

The Honorable Thomas S. Zilly

UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

JAMES JOHNSON, individually and on
behalf of all others similarly situated,

Plaintiff,

v.

COSTCO WHOLESALE
CORPORATION, a Washington
corporation; W. CRAIG JELINEK; and
RICHARD A. GALANTI,

Defendants.

No. 2:18-cv-01611-TSZ

**CONSOLIDATED AMENDED
COMPLAINT FOR VIOLATIONS OF THE
FEDERAL SECURITIES LAWS**

CLASS ACTION

DEMAND FOR JURY TRIAL

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1 By and through his undersigned counsel, Fred D. Davoli (“Lead Plaintiff”) brings this
2 complaint individually, and on behalf of a class of similarly situated persons and entities, against
3 Defendant Costco Wholesale Corporation (“Costco” or the “Company”) and Defendants Richard
4 A. Galanti and W. Craig Jelinek (together, the “Individual Defendants,” and collectively with
5 Costco, the “Defendants”).

6 Lead Plaintiff alleges the following upon personal knowledge as to those allegations
7 concerning Lead Plaintiff and, as to all other matters, upon the investigation of counsel, which
8 included, without limitation: (a) review and analysis of public filings made by Costco with the
9 U.S. Securities and Exchange Commission (“SEC”); (b) review and analysis of press releases
10 and other publications, including those disseminated by certain of the Defendants and other
11 related non-parties; (c) review of news articles; (d) interviews with former employees of Costco,
12 its affiliates, and other third parties; and (e) consultation with individuals with expertise in
13 accounting, information technology systems, and damages. Lead Plaintiff believes that
14 substantial additional evidentiary support exists for the allegations herein that will be revealed
15 after Lead Plaintiff has a reasonable opportunity to conduct discovery.

16 **I. NATURE OF THE CLAIM**

17 1. Costco is a company that sells food and products in bulk to its members and other
18 customers from large warehouses across the world. Costco makes money both by selling
19 products and by selling memberships to use these warehouses and through its website to make
20 purchases. Costco capitalizes on the economy of scale by purchasing products in large volumes
21 at lower prices and then passing on the cost savings of bulk buying to its customers.

22 2. Costco has been in business since the 1980s. From the beginning, Costco was a
23 success. Costco seemingly had a winning formula for maintaining profitability by keeping costs
24 low while continually growing revenue. Costco prided itself on this formula, touting its ability
25 to keep costs down while revenues grew year after year, even amid strong competition. From the
26 inception of the Company, Costco underwent incredible growth – growing from one store in
27

1 1983 in Washington, to 769 stores in 11 countries around the world. Costco is an easily
2 recognized brand with millions of loyal followers.

3 3. But with growth sometimes comes problems. Starting in at least 2017—the year
4 leading up to the Class Period (defined herein)—Costco struggled to control its costs, which it
5 needed to do to remain competitive in the market and to return maximum value to shareholders.
6 These struggles manifested themselves in Costco’s inability to manage one of their most
7 important infrastructure systems – its Information Technology (or “IT”) function. As a result of
8 this failure, Costco’s financial compliance function broke down causing material problems for
9 Costco’s internal controls in financial reporting and ultimately caused Defendants to issue
10 materially false and misleading statements to the market and violate the Sarbanes-Oxley Act of
11 2002 (“SOX”) in the process. Pub. L. No. 107-204. H.R. 3763, 107th Cong.

12 4. As a public company, Costco is subject SOX, a law that was passed in 2002 in the
13 wake of massive accounting frauds that was meant to return personal accountability to the
14 executives of publicly traded companies. In summary, and as more fully described herein, the
15 law requires that as a part of a company’s public filings, the CEO and CFO of a company must
16 certify (called “SOX Certifications”) that they have been involved in the process of designing,
17 implementing, and evaluating the Company’s internal controls. These controls are critical to
18 ensuring the reliability of the Company’s public disclosures. Thus, under SOX, the internal
19 controls themselves are of paramount importance for any public company, and investors rely on
20 SOX Certifications as a beacon of confidence and reliability in the accuracy of the financial
21 metrics that get reported to the market. As a part of the SOX Certification, the CEO and CFO
22 attest to *personally* evaluating the effectiveness of the Company’s internal controls - a task that
23 cannot be delegated.

24 5. Like almost all public companies, Costco relies on its IT Department in large part
25 to comply with SOX. In particular, Costco’s CEO and CFO rely on accounting and compliance
26 software and teams so that they can affirm in SOX Certifications that there are sufficient
27 procedures and internal controls in place for accurate financial reporting. In fact, it is understood

1 that certification of compliance with SOX is indirectly a certification of the robustness of these
2 processes as complying with a well-accepted (*i.e.*, “recognized”) internal control framework.

3 6. It is important for the software and the teams to be robust and for checks and
4 controls to be in place every step of the way. This importance is magnified by the sheer size and
5 complexity of Costco’s operations. In 2018 alone, Costco reported revenues in the amount of
6 more than \$130 billion from its more than 760 warehouses and e-commerce operations, as well
7 as more than \$3 billion in membership fees from its more than 94 million members. Thus, the
8 efforts to make sure financial information is being reported accurately to the market is a huge
9 undertaking, requiring working software, internal audits, internal checks and documentation,
10 sufficient funding, robust training, and an effective and well managed IT team. This significant
11 undertaking is not optional nor a matter of business judgment: SOX compliance is federal law.

12 7. The CEO and CFO of Costco signed SOX Certifications annually and quarterly,
13 including during the Class Period, between June 6, 2018, to October 25, 2018, confirming to the
14 market that they had a robust internal control process in place to ensure the integrity of their
15 financial statements. They also assured the market that the resources they were spending on their
16 IT Department were sufficient to maintain the necessary internal controls – and that this did not
17 change during the Class Period.

18 8. However, unbeknownst to the market, Costco did not have sufficient practices
19 and procedures in place to make sure that its financial reporting function was secure. Numerous
20 former employees of the Company collectively confirm that in the year and months leading up to
21 the Class Period (and during the Class Period), Defendants systematically and consciously
22 deprived Costco’s IT Department of adequate resources and treated the department with disdain.
23 The accounts of former employees converge to describe an attitude at the top of Costco that was
24 hostile to the IT Department. For example, former employees stated that spending on the IT
25 Department was viewed as a “necessary evil” and that the IT Department was an “afterthought,”
26 a mere “cost center,” and had “no oversight” and “no process.” In short, in an effort to manage
27 costs to seem more profitable, Costco sacrificed IT – a department they saw as a waste of money,

1 resources, and time. The IT Department, however, was more than just a “cost center,” it was
2 necessary to ensure SOX Certifications were true and it was necessary to make sure there are no
3 material weaknesses in internal controls related to financial reporting.

4 9. Former employees of Costco collectively confirm that management consciously
5 ignored the needs of the IT Department and as a result it was disorganized, lacked training,
6 lacked funding, and failed to implement governance controls as well as “access controls” and
7 “change controls” over Costco’s sensitive financial information. These “access controls” and
8 “change controls” are particularly important, as they controlled internally who could access and
9 change internal financial data that would ultimately be published to the market. One former
10 employee stated that issues related to processes, access management, and governance controls
11 were identified as having deficiencies throughout the whole IT Department. Another former
12 employee indicated that Costco’s change management had “a lot of gaps,” including incomplete
13 testing and missing approvals. Other former employees said the Company’s failure to establish
14 adequate change management processes led to unauthorized user access to Costco’s IT systems.
15 Another former employee said he attended monthly meetings with Vice Presidents where he
16 raised concerns related to user access and change management process issues but nothing was
17 ever done.

18 10. One former employee said a “baffling” number of former contractors were listed
19 in the Company’s records as still having access to Costco’s systems and that access for third
20 party contractors in the IT Department was tracked in a Google spreadsheet, which relied on
21 manual processes and was easy for employees to change. Additionally, a former employee said
22 access issues were a “common occurrence” at Costco, and another explained that the access
23 issues meant the Company had to “scramble” to try and address any issues before auditors came
24 in. These access and change control deficiencies were material weaknesses in Costco’s systems
25 (*with a “material weakness” being the most severe form of internal control deficiency*) and
26 violated SOX. These access and change control deficiencies were documented internally in a 50
27

1 page report by a contractor who worked performing an audit for the IT Department in 2017 – yet
 2 Defendants did nothing to remedy these weaknesses.

3 11. In addition to the 50 page report that documented these material deficiencies in
 4 access and change control that existed as early as mid-2017, one former Senior Analyst at Costco
 5 confirms that Defendants *actually knew* about the internal control problems in the months
 6 leading into the Class Period, and that the board was kept apprised of these issues as well. This
 7 former employee said that Costco’s weak internal controls “got Board attention,” including
 8 Defendants Jelinek and Galanti, because of the concerns over weak internal controls, and that
 9 Defendants Jelinek and Galanti were involved in conversations related to a material weakness in
 10 Costco’s IT department beginning in February/March 2018 - *just 3 months before the Class*
 11 *Period began*. Despite this knowledge, Defendants shockingly affirmed just three months later
 12 in their 3Q2018 Form 10-Q on June 6, 2018, that their internal controls over financial reporting
 13 were sufficient and that there were no material weaknesses related to their financial reporting.

14 12. Defendants’ failure to dedicate adequate oversight and resources to its IT
 15 Department caught up with them in a very real way. On October 4, 2018, after the markets
 16 closed, Defendants announced that Costco “expects to report a material weakness in internal
 17 control[s]” for financial results reported as of September 2, 2018. A material weakness in
 18 internal controls is a deficiency, or combination of deficiencies, in internal controls such that it is
 19 reasonably possible that a material misstatement of the Company’s quarterly or annual reporting
 20 will not be prevented or detected on a timely basis. On that call, Defendant Galanti admitted that
 21 “the controls weren’t in place,” “we should have done a better job,” and “[the material weakness]
 22 should have been fixed.” The market was rattled by this announcement with comments that
 23 Costco reported a “‘material weakness in internal control’ that spooked investors.” Costco’s
 24 closing stock price dropped on this news from \$231.68 on October 4, 2018, to \$218.82 on
 25 October 5, 2018, a drop of 5.55% on heavy volume, despite the Company beating analysts’
 26 estimates for earnings per share and revenue for 4Q2018. But the market was still unaware of
 27 the full extent of the problem, with Bloomberg noting that “a company official,

1 [Defendant Galanti], was cryptic on [his] call with analysts,” and another reporter noting that
 2 “[i]n a *vague* statement, the warehouse indicated that the access issue involved both internal
 3 employees and contractors.”

4 13. On October 26, 2018, Defendants revealed the true extent of the problem,
 5 explaining that the internal control deficiencies were substantial and *would likely take the entire*
 6 *fiscal year to fix*. They also explained that Costco was instituting significant remedial measures
 7 to deal with their material weakness in internal controls. The remedial measures included
 8 implementing (1) a compliance oversight function, (2) a training program on internal controls,
 9 (3) a documentation program on internal controls, (4) enhanced risk assessment procedures and
 10 controls for IT systems, and (5) a sufficient internal control review and testing plan. The
 11 significance of these remedial measures is twofold. First, they serve as admissions by
 12 Defendants that these measures were *not* in place during the Class Period, thus serving as
 13 confirmation that Defendants SOX Certifications and other statements about internal controls
 14 were false and misleading when made. Second, they serve as corroboration that Defendants
 15 were (at a minimum) deliberately reckless because they did not have these measures in place to
 16 begin with.

17 14. On this news, Costco’s stock dropped again, from a closing price of \$226.40 on
 18 October 25, 2018, to \$218.19 on October 26, 2018, a 3.63% drop on heavy volume. To this day,
 19 Costco has not been able to remediate the issues with the material weakness in its internal
 20 controls. As a result of Defendants’ fraud, Lead Plaintiff and class members suffered hundreds
 21 of millions of dollars in losses.

22 **II. JURISDICTION AND VENUE**

23 15. This complaint alleges claims which arise under (1) Section 10(b) of the
 24 Securities Exchange Act (the “Exchange Act”), 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated
 25 thereunder by the SEC, 17 C.F.R. § 240.10b-5; and (2) Section 20(a) of the Exchange Act, 15
 26 U.S.C. § 78t(a).

1 16. This court has subject matter jurisdiction over this action pursuant to Section 27
2 of the Exchange Act, 15 U.S.C. § 78aa, and 28 U.S.C. § 1331. During the Class Period, Costco
3 was incorporated in the state of Washington, listed its stock on the NASDAQ, and maintained its
4 global headquarters in Issaquah, Washington. During the Class Period, both of the Individual
5 Defendants were members of Costco's senior management.

6 17. Venue is proper in this judicial district pursuant to Section 27 of the Exchange
7 Act, 15 U.S.C. § 78aa, and 28 U.S.C. § 1391(b). Costco maintained its global headquarters in
8 Issaquah, Washington, which included the Company's executive offices. During the Class
9 Period, each of the Individual Defendants were members of Costco's senior management.

10 18. In connection with the acts alleged in this complaint, Defendants, directly, or
11 indirectly, used the means and instrumentalities of interstate commerce, including, but not
12 limited to, the mails, interstate telephone communications, interstate email communications, and
13 the facilities of the NASDAQ.

14 **III. PARTIES**

15 **A. Lead Plaintiff**

16 19. Lead Plaintiff Fred D. Davoli ("Lead Plaintiff") is an individual who resides in the
17 United States. As set forth in his PSLRA certification (*see* ECF No. 15), Lead Plaintiff purchased
18 Costco securities during the Class Period and suffered damages as a result of the securities law
19 violations alleged herein.

20 **B. Defendants**

21 20. During the Class Period, Defendant Costco was a publicly traded company, listed
22 on the NASDAQ under the ticker COST. It is incorporated in Washington, with its headquarters
23 in Issaquah, Washington. Costco sells goods out of its large warehouse stores to its members
24 and other customers, as well as through its website. In Fiscal Year ("FY") 2018, the Company
25 had net sales of more than \$130 billion and took in membership fees of over \$3 billion. As of its
26 2018 Annual Report, Costco operated 762 warehouses and employed nearly 250,000 people in
27 countries around the world.

21. Defendant Richard A. Galanti (“Galanti”) is Costco’s Chief Financial Officer, an Executive Vice President, and a member of the Board of Directors (the “Board”). Defendant Galanti started with Costco in 1984 and has served in a number of roles with Costco, including Vice President of Finance and Treasurer. Defendant Galanti has been in his current role as CFO and Executive Vice President since October of 1993 and a member of the Board since 1995. As a member of the Board Defendant Galanti attended the Board meetings during the Class Period. During the Class Period, Defendant Galanti signed SEC filings and made public statements to the market about Costco’s operations and compliance with SOX.

22. Defendant Craig W. Jelinek (“Jelinek”) is Costco’s Chief Executive Officer, President, and a member of the Board. He also started with Costco in 1984 and has served in a number of roles with Costco, including Executive Vice President and COO of Merchandising. Defendant Jelinek has been in his current role as CEO since 2012 and President and a member of the Board since 2010. As a member of the Board Defendant Jelinek attended the Board meetings during the class period. During the Class Period, Defendant Jelinek signed SEC filings and made public statements to the market about Costco’s operations and compliance with SOX.

IV. CONFIDENTIAL WITNESSES

23. Lead Plaintiff through its agents interviewed a number of former employees of Costco in order to investigate its claims. Described below in this Section are seven such former employees who provided information to support the fraud alleged herein. Based on these former employee accounts, described in Section VI(J), Lead Plaintiff believes substantial additional documentary and testimonial evidence exists to support its claims.

24. Confidential Witness 1 (“CW 1”) was employed by Costco from 2015 until September of 2018. He¹ was a Senior Compliance Analyst at the Company’s headquarters in Issaquah, Washington. CW 1 reported to a Manager of Information Security and Governance Risk Compliance Gokul Krishnan, who reported to Manager of Information Security Compliance

¹ All CWs will be described and referred to in the masculine to protect their identities.

1 and Identity and Access Management Susan Milroy, who reported to VP of Information Security
 2 and Compliance Tim Bowersock. Through this role in IT, CW 1 was responsible for the
 3 Company's compliance with various privacy regulatory regimes, including GDPR, Payment
 4 Card Industry Security Standards ("PCI"), the California Consumer Privacy Act, and, to a lesser
 5 extent, compliance requirements under the Health Insurance Portability and Accountability Act
 6 of 1996 ("HIPPA") and SOX. CW 1 stated that SOX compliance was a function of the IT
 7 Department generally but the responsibility fell primarily to a single employee, Barbara Egner.

8 25. Confidential Witness 2 ("CW 2") was employed by Costco from at least 2015
 9 until mid-2018. He was employed in the IT department at the Company's headquarters in
 10 Issaquah, Washington. CW reported through a chain that went up to Vice President of
 11 Information Security and Compliance Tim Bowersock. Through this role in IT, CW had insight
 12 into issues affecting IT security.

13 26. Confidential Witness 3 ("CW 3") was employed by Costco as a consultant from
 14 April 2017 until the end of May 2017 at the Company's headquarters in Issaquah, Washington
 15 and reported to Jeremy Guerrero, the Manager of Global SAP² Platform Security and
 16 Compliance, Ryan Ladd, a Director of Global SAP Platform Services, and Dave Miller, a Global
 17 SAP Platforms and Services Manager. CW 3 worked primarily on SAP Application Security
 18 Assessment. Through this role in Costco's IT Department, he was primarily responsible for
 19 performing an assessment of various aspects of the Company's IT Department, including, but not
 20 limited to, Basis, Change Management, Internal Audit, Identity Access Management, and User
 21 Access Administration.

22 27. Confidential Witness 4 ("CW 4") was employed by Costco as a contractor
 23 engaged for an SAP implementation project from May 2018 until November 2018 at the
 24 Company's headquarters in Issaquah, Washington and reported to Dana Cook who reported to
 25 _____

26 ² SAP refers to a company that offers a wide range of business software that allow a company
 27 to track its various parts of its operations, including inventory, revenues, and change
 management.

1 Project Manager Cindi Dear. He worked in Quality Assurance (“QA”) testing and was promoted
 2 to a Defect Lead in August of 2018. Through this role in Costco’s IT Department, CW 4 was
 3 initially responsible for QA testing and then overseeing other workers in that area.

4 28. Confidential Witness 5 (“CW 5”) was employed by Costco as an IT Contract and
 5 Vendor Manager in their IT Department from July 2017 until July 2018 at the Company’s
 6 headquarters in Issaquah, Washington and reported to Jill Hendrick, a Manager in Vendor and
 7 Contract Management, Finance and Planning, who in turn reported to Kristian Erickson, an IT
 8 Director, who in turn reported to Vice President Chris Rylance, who in turn reported to Senior
 9 Vice President of Information Systems Jim Rutherford. Through his role with Costco’s IT
 10 Department, CW 5 was primarily responsible for working as part of a program assessing
 11 Contracts Procurement Asset Management (“CPAM”), which provided recommendations to
 12 improve Costco’s IT contracts procurement process.

13 29. Confidential Witness 6 (“CW 6”) was employed by Costco as a Compliance
 14 Analyst from 2012 until August 2018 at the Company’s headquarters in Issaquah, Washington
 15 and reported to Michel Chambers, a Manager who reported to IT Director Terry Patane, who
 16 reported to Tim Bowersock, a VP of Security and Compliance. Through his role in Costco’s IT
 17 Department, CW 6 was primarily responsible for assessing security controls by collecting
 18 evidence.

19 30. Confidential Witness 7 (“CW 7”) was employed by Costco as a Senior Business
 20 Analyst from late 2014 until July of 2018 at the Company’s headquarters in Issaquah,
 21 Washington and reported to IT Manager Ramon Nichols who reported to IT Director Laine
 22 Seeley, who in turn reported to Terry Williams, a Global Supply Chain VP. Through his role in
 23 Costco’s IT Department, CW 7 was primarily responsible for working with outside consultants
 24 on vetting requirements for new systems designs.

25 **V. CONTROL PERSON ALLEGATIONS**

26 31. The Individual Defendants, by virtue of their senior positions at Costco, directly
 27 participated in the management of the Company, were directly involved in day-to-day operations

of the Company at the highest levels, and were privy to confidential, proprietary information concerning the Company and its business, operations, internal controls, growth, IT spending, financial statements, and financial condition, as alleged herein. As set forth below, the distribution of misleading information and the failure to convey material information to the public was the result of their collective actions and inactions.

32. Defendant Galanti signed the Company's Form 8-K filed on October 4, 2018, and both of the Individual Defendants signed Costco's 2017 Form 10-K filed on October 18, 2017, the Company's 3Q 2018 Form 10-q filed on June 6, 2018, the Company's 2018 Form 10-K filed on October 26, 2018, and the SOX Certifications accompanying those Form 10-Ks and that Form 10-Q.

33. The Individual Defendants were aware of the deficiencies in the internal controls and that the Company was deliberately reckless in failing to provide the IT Department with adequate resources. As the top two executives in the Company, the Individual Defendants had substantial influence and control over the spending and operations of the Company. Through their roles at the Company and as the signatories on the Company's SOX Certifications, the Individual Defendants were personally responsible for the implementation and operation of effective internal controls related to financial reporting.

34. Through these and other forms of participation and control, the Individual Defendants had substantial influence over Costco, the information it distributed, and the actions it engaged in.

VI. SUBSTANTIVE ALLEGATIONS

A. The Nature of Costco's Business

35. Costco and its subsidiaries operate membership warehouses that offer members low prices on a limited selection of nationally-branded and private-label products in a wide range of merchandise categories. Costco buys and sells many of its products in bulk, and capitalizes on an economy of scale – in other words, Costco is able to purchase products at a lower per-unit cost when they are purchased in large quantities, and passes on that bulk cost savings to its

members. The Company endears itself to its customers through its low-frills warehouses, low prices, and popular deals in the food courts of the warehouses.

36. Costco makes money by selling products in its warehouses and by selling memberships to individuals and companies. The memberships allow the members to shop in the warehouses and the website. Historically, the Company made approximately 98% of revenue from sales of its goods and 2% of its revenue from membership fees.

B. Costco's Background

37. Costco was born of the marriage between two companies - Costco and Price Club. Costco and Price Club both started out small and quickly became successful warehouse clubs. Costco in its current iteration was formed when Price Club and Costco merged in 1993, forming PriceCostco. That year alone, PriceCostco had over 200 membership warehouses, annual sales of more than \$15 billion, 18 million members, and 43,000 employees. PriceCostco officially changed its name to Costco Companies, Inc. in 1997 and assumed its current name, Costco Wholesale Corporation in 1999. Since the merger, Costco has become the self-proclaimed "world's most successful warehouse club." In 2018, the Company was responsible for more than \$138 billion in sales revenue.³

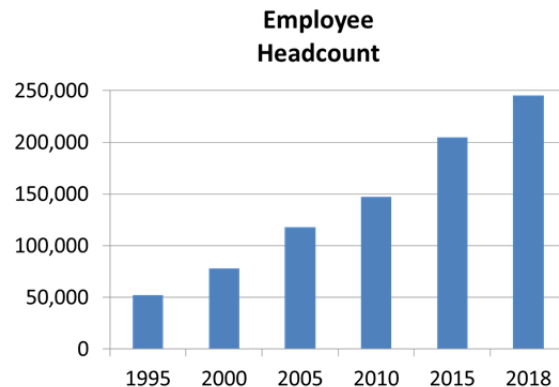
38. For the period ended February 17, 2019, Costco operated 769 warehouses worldwide: 534 in the United States (U.S.) located in 44 states, Washington, D.C., and Puerto Rico, 100 in Canada, 39 in Mexico, 28 in the United Kingdom (U.K.), 26 in Japan, 15 in Korea, 13 in Taiwan, 10 in Australia, two in Spain, and one each in Iceland and France. The Company operates e-commerce websites in the U.S., Canada, Mexico, U.K., Korea, and Taiwan.

³ The Company operates on a 52/53 week fiscal year basis, with the fiscal year ending on the Sunday closest to August 31. Fiscal 2018 is a 52-week year ending on September 2, 2018. References to the third quarters of 2018 and 2017 relate to the 12-week fiscal quarters ended May 13, 2018, and May 7, 2017, respectively. References to the first thirty-six weeks of 2018 and 2017 relate to the thirty-six weeks ended May 13, 2018, and May 7, 2017, respectively.

C. Growing and Maintaining a Competitive Advantage

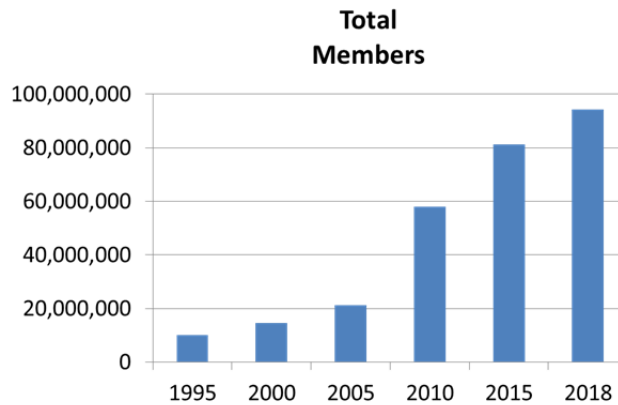
39. Costco operates in a highly-competitive industry driven by high revenue but tight margins. As a warehouse wholesaler, the Company maintains a no-frills culture and attracts customers by keeping prices down. Its market position and value depends on being able to operate successfully on a massive scale, while keeping costs low. The Company's efforts to keep operating costs down takes many forms. For example, the Company carries fewer unique products than its competitors, and the Company maintains a leaner infrastructure that its competitors. Defendant Jelinek has boasted about furnishing his boardroom with faux-wood tables and not spending on a public relations staff. Perhaps most famously, Costco does not even offer customers shopping bags. Costco prioritizes passing savings onto its customers in the form of lower prices and, therefore, corporate growth depends on increasing revenue through expansion while maintaining a low-frills operation.

40. The Company has grown its warehouse operations from a single location at its founding in 1976 to more than 200 warehouses at the time the Costco/ Price Club merger was completed in 1994. Between 1994 and the start of the Class Period, Costco opened 528 new stores representing a growth of its warehouse locations of nearly 340%. During this same time, employee headcount grew from approximately 47,000 to approximately 245,000 representing an increase of over 500%.

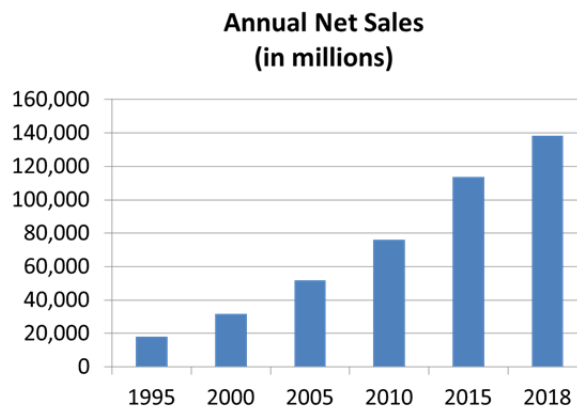


41. Membership has also grown precipitously over the years. The Company reported more than 80 million members in 2015 and more than 94 million in 2018. As noted in their 2017

Form 10-K, Costco placed an emphasis on their ability to “maintain membership loyalty” and noted that “[m]embership loyalty and growth are essential to our business model.”



42. The growth in the size and complexity of Costco’s operations is also evidenced in the steady increase in the Company’s net revenues. As noted above, at the time of the merger in 1994 Costco had approximately \$15 billion in annual net sales and that number had already increased to nearly \$18 billion in 1995. Over the next 20 years, the Company’s annual net sales increased more than six times that number reaching more than \$113 billion in 2015. As noted above Costco reported more than \$138 billion in net sales in 2018 and additionally reported more than \$3 billion in revenue from membership fees.



43. Throughout its history Costco has impressed analysts by continuing to grow while maintaining low costs. For example, on October 1, 2015, Cowen and Company explained that it was “most encouraged that COST’s market potential continues to grow as its brand awareness”

grows. A February 2, 2018, report from JP Morgan indicated that “[o]n top of the expansive international opportunity, COST remains a differentiated story (particularly in consumer staples) with high single digit revenue growth potential.” On May 24, 2018, less than two weeks prior to the start of the Class Period, Barclays stated that Costco was “operating from a position of strength and has meaningfully widened the gap on share gains and execution relative to peers.”

D. Costco’s Drive to Keep Costs Down

44. Costco has repeatedly stated that its financial performance depends “heavily” on its ability to control costs, which it strives to do through a “never ending quest for efficiency.” In a presentation to the Issaquah Chamber of Commerce on April 12, 2018, Defendant Jelinek noted that growth was absolutely critical to maintaining Costco’s share price and keeping investors happy. However, Costco as a company was also committed to paying a higher average hourly wage than its competitors and also had a very forgiving return policy. Defendant Jelinek noted that Costco historically had a difficult time convincing investors to accept its high wage-related expenses, especially given the Company’s focus on low-costs. But Jelinek stated on April 12, 2018, that the Company had “gotten past that because [it] has been able to grow the business.” In order to maintain margins while simultaneously maintaining growth sufficient to satisfy investors, however, the Company had to keep expenses down in areas other than wages and product costs. According to the Company’s 2018 Form 10-K, Costco spent approximately 90% of its operating expenses on product costs leaving only 10% for all other operating expenses, which includes Costco’s famously high wages.

45. Costco has several colorful examples of its extreme efforts to keep both prices and costs down. For example, Costco is known for the \$4.99 rotisserie chicken. When the price of chicken feed began to rise threatening the cost of Costco’s supply, rather than raise the price of the rotisserie chicken, the Company decided to build a chicken plant. The Company also owns and operates two hot dog plants in order to maintain Costco’s \$1.50 hot dog and soda combo.

46. The market often referred to Costco as a “long moat” or “wide moat” company meaning that the Company’s fanatical dedication to keeping down costs allowed it to build up a significant competitive advantage over other retailers. Costco continually impressed investors by maintaining comparatively low selling, general and administrative (“SGA”) spending even while competitive factors put pressure on the Company. On March 1, 2018, Deutsche Bank Markets Research stated Costco’s “competitive moat [was] under greater threat while its digital platform lags peers.” However, on March 2, 2018, Macquarie Research noted that while competitive factors had begun to create concern, Costco “continue[d] to have a wide moat around its business” given the Company’s margins and other factors. Additionally, on March 8, 2018, RBC Capital Markets noted Costco had “significant competitive moats due to their limited SKU selection and rock-bottom pricing.” On August 21, 2018, an Oppenheimer report even went so far as to say Oppenheimer “believe[d] COST has one of the most defensible moats in all of retail.” Further, on September 10, 2018, BMO Capital Markets noted that Costco’s “valuation could expand as the company widens its competitive moat with a deeper digital relationship with its loyal customer base.”

E. SOX Requires Adequate Internal Controls and Directly Makes Senior Management Responsible For Those Controls

47. As a public Company, Costco was subject to certain financial reporting and auditing obligations. In particular, Costco was subject to SOX which imposes specific obligations on companies and senior executives to maintain proper internal controls over financial reporting and imposes upon the CEOs and CFOs of public companies a duty to affirmatively state in a company’s public filings that the Company’s internal controls are adequate and that they have personally evaluated them.

48. To understand the specific requirements imposed by SOX—and what it means to state that “internal controls” are adequate—it is helpful to understand the context in which SOX was passed.

1 49. Prior to SOX, under Section 13(b)(2) of the Exchange Act (15 U.S.C.A. §
2 78m(b)(2)(B)), issuers of publicly registered securities were required to “devise and maintain a
3 system of internal accounting controls sufficient to provide reasonable assurances” that
4 transactions are recorded as necessary (i) to permit the preparation of proper financial statements,
5 (ii) to maintain accountability for assets, (iii) so that access to assets is permitted only in
6 accordance with management’s general or specific authorization, and (iv) so that the recorded
7 accountability for assets is compared with actual assets at regular intervals and appropriate action
8 is taken with respect to any difference.

9 50. On March 6, 2002, President Bush announced ten directives aimed at targeting the
10 accounting fraud epidemic, including the collapse of Enron. Two of those directives are relevant
11 here: (a) “CEOs should personally vouch for the veracity, timeliness, and fairness of their
12 companies’ public disclosures, including their financial statements” and (b) “[f]irms’ accounting
13 systems should be compared with best practices, not simply against minimum standards.” The
14 SEC acted on these directives by proposing rules (1) requiring the CEOs and CFOs of public
15 companies to personally certify their financial records; and (2) requiring companies to have
16 systems in place to bring all relevant information concerning internal controls to the attention of
17 the CEO and CFO.

18 51. Then, on June 25, 2002, the situation intensified as WorldCom announced that it
19 had overstated income by over \$3 billion. The fraud at issue in WorldCom was shockingly
20 simple; certain expenses were being booked as assets, rather than getting deducted from net
21 income. The simplicity and magnitude of this fraud prompted Congress to finally take firm
22 action. These frauds were the result of simple failures, which would have been prevented by
23 adequate internal controls. Where those controls are lacking, there is nothing to prevent
24 employees from drastically misrepresenting the financial condition of a company.
25
26
27

52. In reaction to a number of frauds of varying magnitudes, including WorldCom, Congress took action by passing SOX, which strengthened the preexisting legal obligation to maintain internal controls and reaffirmed that the failure to have such controls is *itself* a serious violation of the law—a violation which does not depend on whether the lack of controls resulted in financial misstatements. Specifically, Title IV of SOX addresses the need for internal controls and enhanced financial reporting for publicly traded companies. Public companies are subject to enhanced reporting requirements related to financial transactions, including off-balance-sheet transactions, pro-forma figures, and any stock transactions of corporate officers. A core policy goal advanced by SOX is personal involvement of and accountability at the most senior levels of a company.

53. Section 302 of SOX (implemented through 17 C.F.R. § 240.13a–15) requires an issuer of registered securities to “maintain disclosure controls and procedures . . . and internal control[s] over financial reporting.” The term “disclosure controls and procedures” is defined by the relevant regulation to include “controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.” Internal control over financial reporting is defined as follows:

The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

1 (2) Provide reasonable assurance that transactions are recorded as
 2 necessary to permit preparation of financial statements in
 3 accordance with generally accepted accounting principles, and
 4 that receipts and expenditures of the issuer are being made only
 in accordance with authorizations of management and directors
 of the issuer; and

5 (3) Provide reasonable assurance regarding prevention or timely
 6 detection of unauthorized acquisition, use or disposition of the
 7 issuer's assets that could have a material effect on the financial
 statements.

8 54. Thus, Section 302 imposes an affirmative obligation on a company to ensure that
 9 it has systems in place to safeguard the accuracy of its financial reporting, recorded as necessary,
 10 that receipts and expenditures are being made "only in accordance with authorizations of
 11 management and directors of the issuer," among other requirements. Furthermore, the internal
 12 controls must be "under the supervision of, the issuer's principal executive and principal
 13 financial officers."

14 55. The requirement that the existence of controls be overseen by the CEO and CFO
 15 (or equivalents) is so important to the SOX scheme, that it also requires that those officers file
 16 public certifications, known as Section 302 Certifications, or SOX Certifications, whereby these
 17 officers must *personally* attest to their role in supervising the controls and the quality of those
 18 controls through an SEC provided form. As relevant here, the most important sections of the
 19 SEC form are as follows:

20 (1) "The registrant's other certifying officer(s) and I are
 21 responsible for establishing and maintaining disclosure
 22 controls and procedures . . . and internal control . . . for the
 registrant and have:

23 (a) Designed such disclosure controls and procedures, or
 24 caused such disclosure controls and procedures to be
 25 designed under our supervision, to ensure that material
 26 information relating to the registrant, including its
 consolidated subsidiaries, is made known to us by others
 within those entities, particularly during the period in
 27 which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

* * *

(2) The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information. . . .

56. In addition to these certifications, SOX also requires, through Section 404 (as implemented by 17 C.F.R. § 240.13a-15(c)), management of issuers of registered securities to "evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting." Further, the rule requires that this "evaluation" must be based on a "suitable, recognized control framework that is established by a body or group that has followed due-process procedures" in developing that framework.

57. In partial summary, SOX affirmatively requires a company, its CEO, and its CFO to take responsibility for maintaining affirmative controls and to personally evaluate those controls on a regular basis. SOX defines those necessary controls to include procedures on limiting user access. The personal evaluation of the CEO and CFO must be conducted according

1 to “recognized” procedures (defined below in Section VI(G)), and requires them to attest to
2 having done so.

3 58. Violation of SOX can result in significant fines and penalties regardless of
4 whether a company is found to have misstated its financial results during the relevant period.
5 Section 906 of SOX may also impose criminal penalties on executives for falsely certifying
6 compliance with SOX. As a result, companies that are not in compliance with SOX, risk
7 financial penalties and fines and will need to expend whatever resources are necessary to
8 remediate the deficiencies.

9 **F. The Importance of IT Controls for Public Companies**

10 59. Like other public companies, Costco automated much of its sales function, which
11 rolled up into its financial reporting function. Costco also relied on various forms of software to
12 monitor and regulate its business operations. For example, CWs 2, 6, and 7 confirm that Costco
13 used SAP, which provides a wide range of products and software that cover an array of business
14 functions, including inventory tracking, change management, revenue management, and
15 enterprise resource planning. Other CWs confirm that Costco used other kinds of software such
16 as Archer and ServiceNow, which are programs that support business-level governance, risk, and
17 compliance controls.

18 60. Costco relied heavily on these programs to track sales and revenue, and therefore,
19 as a part of using and engaging this software it was important for Costco to have sufficient IT
20 controls in place. Defendants acknowledged the importance of IT controls to Costco’s business
21 operations and brand reputation. For example, in Costco’s 2017 Form 10-K, Defendants noted
22 that the failure to “maintain the privacy and security of . . . [its] business information” could
23 damage the Company’s reputation with members. Further, both the warehouse and online
24 businesses “depend[ed] upon the secure transmission of encrypted confidential information.”
25 Defendants also alerted the market that a “failure to adequately update [its] existing systems and
26 implement new systems” could adversely affect the business, even going so far as to
27 acknowledge that a significant interruption in the Company’s information technology systems

“could have a material adverse effect on [its] business and results of operations.” In detailing the importance of IT to its operations, Costco also assured the market that it was making significant investments in its IT Department and had adequate change management processes in place to mitigate any risk related to changes in its IT systems.

G. Costco’s Internal Controls Framework and Management’s Obligations Regarding that Framework

61. In consultation with an accounting expert, Lead Plaintiff alleges that Costco’s representations of compliance with internal controls had a specific and well understood meaning, as described in the following paragraphs in this Section.

62. As previously noted, Costco was required to evaluate and ensure compliance with internal controls using a “recognized” framework. The “control framework” that Costco purportedly used to evaluate internal controls and to assert compliance therewith, was known as the Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO Framework”). This well accepted industry framework was an expansion upon the earlier 1992 COSO Framework, and was released in substantial part to address broad changes in internal control attributable to the increased relevance and sophistication of information technology systems.

63. The COSO Framework observes that internal controls are likely to require modification when new technology is implemented. In its 2017 Form 10-K, Costco informed investors that it was in the process of “significant technology investments to improve or replace critical information systems and processing capabilities.” These circumstances created an adverse risk to Costco’s ability to report the financial results of operations. Costco also asserted, however, that its change management processes mitigated that risk. Change management consists of a company’s processes for adding or modifying users and devices, as well as installing or updating information technology. In addition, it involves monitoring changes, such as when a change occurred and who made the change.

64. Adequate controls around IT are critical to an adequate program of internal controls. Thus KPMG, Costco's independent auditor, emphasized in publicly available guidance that management must assess the adequacy of the entity's IT personnel to design and assess IT-related internal controls. KPMG also emphasized management's obligation to ensure the right IT personnel exist to: (1) understand and document the flow of information through IT systems, (2) identify what could go wrong, (3) design IT-related controls, (4) monitor the effectiveness of IT controls, and (5) evaluate the impact of IT deficiencies.⁴

65. The SEC's internal controls implementation guide, SEC Release No. 33-8810, also addresses the significance of IT-related controls. Specifically, that release states "the proper and consistent operation of automated controls or IT functionality often depends upon effective IT general controls." Indeed, according to Costco's 2018 Form 10-K, "[i]nternal controls related to the operation of technology systems are critical to maintaining adequate internal control over financial reporting." Consequently, the COSO Framework requires that entities evaluate the design, implementation and effectiveness of general IT controls relevant to the effective operation of the process level automated control activities.

66. The COSO Framework identifies five components of internal control. The first of these components relates to the overall control environment, which includes core elements such as employing competent individuals. The second relates to the assessment of risk. The third, is utilizing effective control activities. The fourth requires the generation and use of quality information to assess internal controls. The fifth relates to monitoring and evaluating internal controls. Each of these components is based on underlying principles. Within the 2013 COSO Framework, there are seventeen total principles, of which fourteen reflect IT considerations.

67. One of the seventeen principles required by the COSO framework is Principle 11, which requires that "[t]he organization selects and develops general control activities over technology to support the achievement of objectives." This principle specifically serves to

⁴ https://frv.kpmg.us/content/dam/frv/en/pdfs/2018/R21_ICOFR_Reference_Guide.pdf

1 require Information Technology General Controls (ITGCs), which are used to maintain the
2 integrity of information and security of data. ITGCs are a particular part of a company's control
3 activities. Specifically, ITGCs are internal controls, such as policies and procedures that relate to
4 access and use of IT applications. ITGC's contribute to an entity's efforts to ensure appropriate
5 segregation of duties has been achieved. Segregation of duties is a key tool to reduce the risk of
6 error or inappropriate or fraudulent actions. As part of effective segregation of duties, ITGCs
7 must ensure that those users who have access to financial reporting and have the ability to make
8 changes to the financial reporting metrics ("access control" and "change control") are strictly
9 regulated and monitored so that only the correct individuals have access to a company's financial
10 systems.

11 68. Even more specifically, Chapter 7 of the COSO Framework provides four points
12 of focus to "highlight important characteristics relating to [Principle 11]." Those points of focus
13 are described below.

14 69. Point of Focus 1 requires a company to "determine[] dependency between the use
15 of technology in Business Processes and Technology General Controls," which correspondingly
16 requires management to understand the dependencies between business processes, automated
17 control activities, and technology general controls. This point of focus addresses the fact that the
18 effectiveness of process-level controls depends on ITGCs.

19 70. In Release No. 33-8810, the SEC provides an example of this dependency. The
20 SEC's example describes the controls surrounding the formation of significant accounting
21 estimates, which for Costco may include estimating sales returns. Such an estimate involves
22 process-level controls to accumulate source data such as sales activity used to develop the
23 accounting estimate. The effectiveness of those process-level controls, however, depends on the
24 effectiveness of ITGCs, including what users were authorized to identify, assemble, and modify
25 that sales data and what changes the users were authorized to make to the data collection
26 parameters. A deficiency in such controls could, for example, enable an IT user without
27 knowledge of the relevant accounting requirements to implement a program change that

1 negatively impacts the aggregation of data used for the accounting estimate. A deficiency in
2 such a control may be exacerbated if an organization is large and sprawls into various locations
3 across the country or the world.

4 71. Point of Focus 2 requires management to “establish[] relevant technology
5 infrastructure control activities,” which relates to the selection and development of the
6 technology infrastructure to help ensure the completeness, accuracy, and availability of data for
7 financial reporting. This point of focus addresses internal controls designed to ensure data used
8 for financial reporting is complete and accurate. Such controls are critical when data is
9 transferred from one system to another, including, for example, data warehouses. ITGCs must
10 ensure that all data that should be transferred has been transferred, and conversely, that data that
11 should not be transferred has not been transferred. Using the example above, process-level
12 controls may employ correct math to calculate the sales returns reserve, but if unauthorized users
13 had implemented changes (or authorized users had implemented incorrect changes) that caused
14 returns from certain warehouses, time periods, or product categories to be excluded (or over
15 included), the data relied upon for financial reporting was at-risk of being incomplete or
16 inaccurate.

17 72. Point of Focus 3 requires a company to “establish[] relevant security management
18 process control activities,” which requires management to “restrict technology access rights to
19 authorized users commensurate with their job responsibilities and to protect the entity’s assets
20 from external threats.” This point of focus most directly addresses user access controls. User
21 access controls govern the ability to input data, process data, maintain the integrity of data, and,
22 ultimately allow the data to be output for financial reporting. User access controls include
23 considerations such as whether users have been set up appropriately based on an individual’s
24 employment status, position, and changes thereto, including which users are authorized to make
25 such changes. User access controls also include the adequacy of ongoing review of user
26 authority levels, and require that information about who has the ability to access certain
27

1 information be maintained in a secure way. Stated differently, user access controls are critical to
 2 ensure access is consistently restricted to only appropriate and authorized users.

3 73. Point of Focus 4 requires a company to “establish[] relevant technology
 4 acquisition, development, and maintenance process control activities” which requires
 5 management to “select[] and develop[] control activities over the acquisition, development, and
 6 maintenance of technology and its infrastructure to achieve management’s objectives.” This
 7 point of focus addresses change management. Companies are required to have “a change
 8 management process . . . in place to track changes from initiation to final disposition.” These
 9 changes may arise from a “problem in the technology that needs to fixed” or a request from a
 10 user. Additionally, “[t]he extent and rigor of the controls over the initiative should be sized
 11 accordingly.” The ITGCs outlined in Point of Focus 4 “also apply to the ongoing development
 12 and maintenance of technology.” Similar to user-access controls, change controls also include
 13 the adequacy of ongoing review of change authority levels, and require that information about
 14 who has the ability to change certain information be maintained in a secure way.

15 74. Furthermore, management is obligated to gather evidence to evaluate whether
 16 internal controls are effective. As stated in SEC Release No. 33-8810, the evaluation considers
 17 factors such as (1) did controls operate as designed, (2) were the controls applied consistently,
 18 (3) did personnel performing controls possess the necessary authority and competence to operate
 19 the control effectively. If a control is not designed or operating effectively, a deficiency exists
 20 that management must evaluate.

21 75. ***A material weakness is the most severe form of internal control deficiency.*** As
 22 stated in SEC Release No. 33-8810, a material weakness is a deficiency, or a combination of
 23 deficiencies, in internal controls, such that it is reasonably possible that a material misstatement
 24 of a company’s annual or interim financial statements will not be prevented or detected on a
 25 timely basis. The term “reasonably possible” means the chance of the future event or events
 26 occurring are more than remote but less than likely – thus, “reasonably possible” is a stringent
 27 standard in what it requires companies to report. As discussed below, Costco’s management

acknowledged a material weakness existed, causing its internal controls to be ineffective as of September 2, 2018. The evidence here indicates that the material weakness stretched all the way back to the start of the fiscal year, or September 2017, as confirmed by an accounting expert.

H. The Structure of Costco's IT Department

76. For a public company to have the adequate internal controls described above, a company must have a robust and fully functioning IT Department with IT spending commensurate with the size and complexity of a company. IT Departments at a public company are generally structured into different departments or functions, including; (1) development; (2) quality assurance ("QA"); (3) security; (4) internal audit; and (5) management oversight. The five departments and their functions are broken out below:

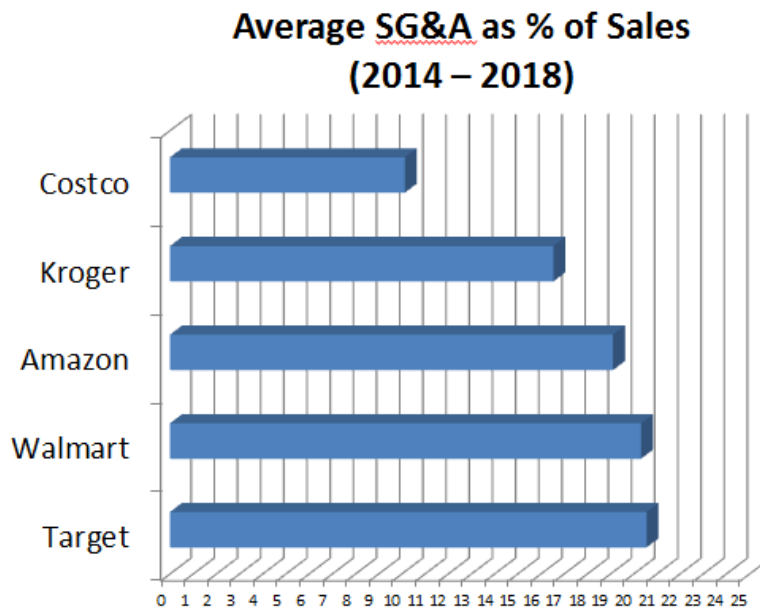
- a. **The Development Group**: writes and tests software to ensure that software meets the requirements for the program or project.
- b. **QA**: performs independent testing on behalf of management and the business unit to ensure that requirements have been met. QA also performs regression testing as a part of the change management process to ensure that changes to programs have not broken previously working software.
- c. **Security**: is tasked with ensuring that the measures and controls implemented meet the policies, standards, guidelines, and compliance requirements of the organization and are effective in meeting a company's stated control objectives.
- d. **Internal Audit**: ensures that the applications and controls in the IT Department are sufficient to maintain the business as a going concern. As noted above, companies must spend and commit resources to the IT Department at a level commensurate with their size to maintain those applications and controls. The internal audit group is charged with conducting audits and risk assessments on those applications and controls.

e. **Management Oversight, or Governance**: provides a company with an additional layer of controls to ensure that all the groups within the IT Department are functioning properly and the risk posed by the department's operations are being accurately assessed and addressed. A proper functioning management oversight committee is also designed to give the CFO and CEO confidence when signing a company's quarterly and annual SEC filings, including the certifications required pursuant to SOX. The certifications signed pursuant to SOX are of particular importance to the CEO and CFO as they are required to personally oversee the functioning of a company's internal controls. (See Section VI(E)). While the CEO and CFO are able to reasonably delegate the actual design and implementation of the policies and procedures, per the certifications they sign they remain personally responsible for evaluating those controls and are ultimately responsible for the effectiveness of a company's internal controls.

I. Costco's Comparatively Low SG&A and IT Spending

77. As of the end of FY 2018, Costco spent about 90% of its operating budget on product costs and only about 10% on SG&A spending, which consists of a company's costs not related to making a product or performing a service, including IT costs and employee-related expenses like salary and benefits. Costco has publicly acknowledged that "[b]ecause our business is operated on very low margins, modest changes in various items in the income statement, particularly merchandise costs and selling, general and administrative expenses, can have substantial impacts on net income." Thus, Costco was incentivized to keep SG&A spend down in an effort to keep net income up. Coupled with Costco's focus on keeping hourly wages higher than its competitors, this left only a small piece of the operating expense pie for IT spending (a subset of the SG&A spend). Simply put, the Company needed to find a way to do more with less.

78. In fact, SG&A as a percent of sales stands out among Costco's financial metrics as one that has not grown in any meaningful way through the Company's history. In 1995, years before technology began to dominate both business and daily life, Costco's SG&A as a percent of net sales was just under 9%. In 2018, when technology is all but unavoidable, Costco's SG&A as percent of net sales was barely over 10%, similar to the Company's average spending over the past five years. For perspective, in Costco's 2018 Form 10-K, Defendants identified similar public companies as competitors, including four companies with publicly available data on SG&A spending going back at least five years⁵; (1) Amazon.com, Inc. ("Amazon"); (2) The Kroger Co. ("Kroger"); (3) Target Corp. ("Target"); and (4) Walmart Inc. ("Walmart"). Each of those companies averaged greater than 15% of SG&A as percent of net sales and Target and Walmart each averaged greater than 20%. While over the past three years, each of those companies have increased their SG&A as a percent of net sales, Costco has inexplicably decreased that percentage.



⁵ Defendants also listed BJ's Wholesale Club Holdings, Inc. ("BJ's"). BJ's is not included in the chart because in the only Form 10-K available the data only went back to 2016, but in the three years for which data is available BJ's SG&A was approximately 16% of net sales.

J. Costco Failed to Provide IT with Adequate Attention and Resources Causing a Material Weakness in Internal Controls

79. Despite spending less on SG&A as a percent of net sales than its competitors (and by implication on IT spend), Defendants repeatedly assured the public that it had sufficient internal controls to certify the reliability of its financial reporting. For example, Defendants asserted two main points in their SEC filings during the Class Period. First, in incorporating the risk language from their 2017 Form 10-K, they said that they were “currently making, and [would] continue to make, significant technology investments to improve or replace critical information systems and processing capabilities.” Second, the Form 10-Q also included certifications from Defendants Jelinek and Galanti pursuant to SOX. As detailed above, in passing SOX, Congress reinforced the importance not only of internal controls, but also the importance of senior management’s involvement in ensuring the adequacy of the Company’s internal controls over financial reporting. In those certifications, Defendants Jelinek and Galanti each attested they were “responsible for establishing and maintaining . . . internal control over financial reporting.” The Individual Defendants specifically stated that they each “designed . . . or caused such internal control over financial reporting to be designed under [their] supervision.” Those controls were designed “to provide reasonable assurance regarding the reliability of financial reporting” and the Individual Defendants attested to the effectiveness of the Company’s “disclosure controls and procedures” presented in the Company’s quarterly and annual SEC filings. Further, the Individual Defendants also stated they had personally “[e]valuated the effectiveness of the registrant’s disclosure controls and procedures” presented in the Company’s SEC filings.

80. However, despite Defendants’ assurances to the contrary, Costco was not making significant technology investments, nor was it developing or improving its IT systems and capabilities to ensure that its internal control procedures as it relates to its financial controls were adequate (as SOX requires). Indeed, former employees of the Company collectively confirm that Costco and the Individual Defendants knowingly (or at least deliberately recklessly)

deprived its IT Department of needed resources and oversight which led to the internal control failures that existed during the Class Period, and which Defendants revealed at the end of the Class Period. One former Senior Analyst confirms that Defendants were aware of the internal control deficiencies as early as February/March 2018. Common sense dictates that Defendants *should* have been aware even earlier of these failures given the former employee's accounts and the importance of internal controls.

1. Costco's IT Department was Neglected and Deprived of Resources Necessary to Maintain Adequate Internal Control Processes

81. Throughout the Class Period, Defendants failed to provide the IT Department with sufficient resources to implement and maintain adequate access controls and change management programs and procedures. As discussed in Section VI(E), access controls are physical and electronic controls that prevent unauthorized users from viewing or editing sensitive financial information. This includes securing locations, implementing effective password controls, and monitoring of access that has been granted. Change management procedures consist of the process for adding or modifying users and devices, as well as installing or updating IT programs and changing personnel. Additionally, these important procedures involve monitoring changes to financial information such as when a change occurred and who made the change. Defendants knew, or were deliberately reckless in not knowing, that they were depriving the IT Department of resources to such an extent that the department did not and could not have implemented, operated, or maintained sufficient access control and change management procedures.

82. According to CW 1, a former Senior Compliance Analyst, there was a single Information Security Analyst responsible for collecting the required evidence for SOX compliance and submitting it to KPMG, an IS Compliance Analyst named Barbara Egner.⁶ CW 1 explained that each department had their own manager that was responsible for SOX

⁶ A commercially available database search indicates that Egner remains employed by Costco as IS Compliance Analyst (11/1999 – Present).

1 compliance. CW 1 said Ms. Egner worked closely with KPMG during their audits in providing
2 them with the evidence and access they needed.

3 83. CW 1 described Ms. Egner as “super frustrated” with the SOX compliance
4 process because “management didn’t want to listen.” CW 1 also said that Ms. Egner was left
5 “holding the bag” in the compliance department. CW 1 said Ms. Egner raised critical IT
6 compliance issues to management, including lack of access controls and change management
7 procedures, but once the issue would reach Bowersock’s⁷ level, management would respond by
8 saying “can we get by?” instead of remediating the issue. CW 1 said each audit was a “huge
9 administrative task” for Ms. Egner. When management did take an interest in SOX compliance
10 during KPMG’s audits, CW 1 said they would ask for reports within a day, which reports would
11 normally take a week to generate. He said Ms. Egner spent a lot of time helping the compliance
12 teams who were “spread thin” working with different teams. CW 1 noted that one of the issues
13 he recalled discussing with Ms. Egner was that parts of the system were okay, while “many parts
14 of the system were wide open.” CW 1 added that management did not give SOX compliance the
15 attention it deserved.

16 84. According to CW 1, one result of management’s unwillingness to invest in the IT
17 Department was that the Company ran an “antiquated” I series operating system that caused a lot
18 of “headaches” for IT personnel and there were fewer people that were knowledgeable on
19 Costco’s systems, which caused issues with hiring IT personnel. As another example, CW 1 said
20 projects in PCI-related compliance were run as what CW 1 referred to as “3-4 month fire drills”
21 in which many projects would not actually get finished. He said once the fire drills were
22 complete, the department would go back to minimal staff and unrealistic deadlines.
23 Additionally, CW 1 said there was a lot of turnover in the IT Department and that there were
24 never enough compliance personnel for a company the size of Costco.

25
26 ⁷ A commercially available database search indicates that Bowersock remains employed by
27 Costco as VP, Information Security & Compliance & member of Office of the CIO (12/2014 –
Present). His previous titles were VP, Office of the CIO (2013 – Present) and AVP, Information
Systems (2001 – 05/2013).

1 85. CW 1 added that staff got burned out because of projects not being completed or
2 cancelled due to a lack of sustained direction and focus from senior management. He said that
3 employees in the IT Department would work hard to meet the project deadlines “just to see it fall
4 apart afterwards.” He said that senior management would talk about securing controls, and then
5 lose focus on it and described the situation in the IT Department as one of peaks and valleys.
6 CW 1 added that management treated everything related to security as a project rather than an
7 ongoing process. Additionally, CW 1 noted that there were a number of oversight and
8 governance projects to improve overall compliance in the IT Department that were not
9 completed. He said he was pulled from one PCI project to another because his background was
10 in privacy security. CW 1 also said he did not want to get involved with any SOX projects
11 personally because it was “another program that’s failing” in the department.

12 86. CW 1 dealt primarily with the Company’s efforts to get its IT security in
13 compliance with the impending implementation of GDPR and the potential fine of 4% of global
14 revenues the regulation carries with it. CW 1 stated that when “tech solutions” were suggested
15 by Costco’s counsel, the Company’s executive team would question and resist making the
16 investment. CW 1 added that he attended one or two meetings a week with Bowersock and
17 PWC, who was brought in specifically to address GDPR, where internal control issues were
18 discussed. He said they discussed issues such as how easy it was for anyone to log into a
19 particular system, and that the same kind of weaknesses were found throughout Costco’s IT
20 ecosystem. CW 1 recalled issues coming up with the GDPR compliance review but senior
21 management said security and remediation measures were “too costly” or required “too much
22 headcount.” CW 1 assumed management was assessing what they viewed as. He continued that
23 he believed it would unfortunately take an IT security breach before Costco management took
24 access controls seriously.

25 87. According to CW 2, a former employee with the IT department, there was “room
26 for improvement” in change management and access deficiencies were a common occurrence in
27 Costco’s IT department. Specifically, CW 2 mentioned access deficiencies occurred in certain

1 areas of SAP due to a lack of controls set up in those environments. He explained that if the
2 systems are not locked down appropriately, anyone can go in and find what they're looking
3 for. Additionally, the culture of management at Costco was to view IT spending as a "necessary
4 evil." CW 2 compared the Company's approach to buying insurance after the incident occurs
5 and said that management at Costco was always interested in keeping costs down when it came
6 to the IT department. CW 2 said management's big focus was on keeping the business going and
7 security in the IT department was an "afterthought." CW 2 said that throughout his tenure, his
8 management team tried to raise concerns about IT security.

9 88. According to CW 3, a former consultant with Costco, IT security was an
10 afterthought at the Company. CW 3 said that many companies, including Costco, want to push
11 out SAP as soon as they possibly can and mistakenly think security is not something they have to
12 think of up front. CW 3 also stated the Company had "no true path on change management." He
13 said there were "a lot of gaps" in the Company's change management, including incomplete
14 testing and missing approvals. Additionally, as also noted by CWs 2 and 5, CW 3 indicated that
15 the Company's failure to establish adequate change management processes led to unauthorized
16 user access to Costco's IT systems. CW 3 said it was unusual for a mature company like Costco
17 to lack change management processes, particularly related to SAP. CW 3 said that during his
18 time with the Company, Costco was developing a change management system called ChaRM,
19 which is a change management system for SAP that validates transport requests and houses test
20 documents and approval workflow, among other capabilities. CW 3 said that a colleague that
21 remains with Costco informed him that ChaRM had still not been implemented as of March 2019
22 as a result of pushback from management.

23 89. CW 3 noted specifically that the Governance and Risk Compliance and the
24 internal audit team lacked "the right people for the right team." In the case of the Governance
25 and Risk Compliance department, he said it lacked the necessary staff and communication to
26 effectively perform its function. As to the internal audit team, CW 3 said the workers lacked a
27 sufficient understanding of the business side of the IT Department's applications and internal

1 controls. CW 3 also cited the governance and risk compliance system as another area where
 2 Costco lacked the right team to support the system and the team lacked communication. CW 3
 3 said you cannot have a proper team if they are not communicating with one another.

4 90. According to CW 4, a former contractor with Costco, he worked on the QA team,
 5 which included approximately 30 people divided into three categories; customers, vendors, and
 6 articles. CW 4 worked on the vendor team, that also included business analysts and developers,
 7 and he was focused on migrating the “master data” to a newer SAP system called SAP
 8 S/4HANA, which he described as a “new release.” He could not recall the names of the existing
 9 systems, except he remembered that Costco had been using another SAP system called ECC. He
 10 explained that SAP S/4HANA was a premium SAP product and was supposed to be a
 11 consolidated ERP system for Costco that would improve reporting and provide more structure.
 12 CW 4 said that Costco needed customized systems and data so their developers would write code
 13 for SAP S/4HANA, which was tested by the QA contractors.

14 91. CW 4 explained that management of these projects was organized around the
 15 Agile process and the development of the code was broken into “sprints,” which was a two to
 16 four week timeframe. CW 4 said that there was “slippage” in projects because work was often
 17 slipping from one sprint to the next, and as a result certain projects were months behind schedule
 18 – CW 4 estimated three months. CW 4 said the completion of these “sprints” was delayed
 19 because the projects were not hitting the needed “velocity,” a term of art in the Agile
 20 development process.⁸ CW 4 said that Costco lacked the proper IT resources and specifically
 21 that the Company did not have enough developers to do the work so their timelines were not
 22 achieved. CW 4 also noted that several IT employees left either the Company or the department
 23 and this contributed to the resources problem. One specific project CW 4 described was the
 24 supply chain project, which he said was stalled because at that time Costco cannot execute on

25
 26
 27 ⁸ In the context of the Agile system, “velocity” is a metric for tracking the progress of the
 project by breaking it into phases called “user stories.”

1 one leg without first completing the master data project, since it was the foundation of the other
2 projects.

3 92. Further, CW 4 said his QA team had only been testing portions of the code being
4 implemented rather than performing testing across the board, which he thought would have been
5 better. CW 4 said that in a typical system development lifecycle, QA was supposed to be the
6 “last line of defense” before the system went live. He said the development team was lacking
7 resources and project deadlines were often missed, or the data and coding prepared by the
8 developers was frequently incomplete or missing by the time it was supposed to be tested by CW
9 4’s team. CW 4 said due to the incomplete development, his team identified a number of defects
10 in code which were “showstoppers.” He said these “showstoppers” were not resolved in a timely
11 manner because of a lack of resources. CW 4 said the SAP S/4HANA project was due to go live
12 in April 2019, but the date to go live was pushed out, possibly to June 2019 or later, because of
13 the lack of resources and missed deadlines. Additionally, Costco had to spend more on the
14 project because of the missed deadlines and that some of Costco’s IT personnel, that were not
15 fully dedicated to that project, had less time to work on their typical day-to-day tasks because
16 they had to assist part-time with the SAP S/4HANA project.

17 93. According to CW 5, a former IT Contract and Vendor Manager in the Company’s
18 IT Department, Costco had “no oversight” when it came to the Company’s IT systems and who
19 had access to them. CW 5 also said the Company did not have good IT governance controls in
20 place and the IT environment at Costco was the worst he had experienced and that was why he
21 left the Company. CW 5 said he attended meetings once a month with VPs from the IT
22 Department and raised concerns regarding user access and change management process issues
23 but nothing was ever done. He said he was “shocked” by the lack of oversight and that “nobody
24 cared.” CW 5 described the response from the VPs as indifference and said that no changes were
25 made, and Costco cared more about maintaining vendor relationships than addressing the issues.

26 94. CW 5 also said that many of Costco’s lower level IT employees had been hired
27 from the warehouse as a reward for many years of work at the Company. However, CW 5 said

1 there was “no oversight” of the training of those employees or how they performed in their jobs.
2 CW 5 said the IT Department did whatever they wanted, including taking hour long lunches,
3 hour long breaks, and then staying late to accumulate overtime pay. CW 5 added that these IT
4 employees were also “undeservingly” promoted to IT Manager roles.

5 95. According to CW 6, a former Compliance Analyst with Costco, the culture in the
6 IT Department was “not healthy” and there was general discontent among the employees who
7 felt that management did not understand the needs of the IT Department. CW 6 also said the
8 culture in the IT Department was one where nobody knew what direction the department or its
9 projects were going. CW 6 also stated the Company had a negative view of the IT Department
10 and Costco internally viewed the IT Department as “just another cost center” that was “not
11 adding value.” CW 6 specifically noted that that some of the reasons for that view were that IT
12 had the highest paid employees, major projects were either not getting completed or were over
13 budget, and the IT Department had a high turnover rate. CW 6 noted that the underlying theme
14 was money over improvements. CW 6 also noted that the IT Department lacked direction from
15 management both broadly and as to individual projects. Additionally, CW 6 said he heard about
16 Defendant Jelinek complaining about how much money was spent in the IT Department, the
17 number of employees it had, and that it was often over-budget with no major projects ever
18 seemingly getting done. CW 6 said Defendant Jelinek’s comments were alluded to in
19 department meetings and that he also heard about them through discussions with colleagues.
20 CW 6 also noted that he heard Defendant Jelinek wanted to fix the problem of over-spending and
21 the IT Department had to demonstrate that it was cutting costs.

22 96. CW 6 said beginning around December 2017, during “department engagement
23 meetings,” led by Vice President of Security and Compliance Tim Bowersock and attended by
24 Senior Vice President of Information Systems Jim Rutherford, it was communicated that the
25 Board was making it a “mission” for the year to reduce IT contractor headcount to reduce costs.
26 CW 6 said the contractors were “highly specialized” and there were approximately 700 to 900
27 contractors in the department at that time. He continued that the move to reduce contractor

1 headcount was a “knee jerk reaction” to the IT Department running over budget. CW 6 said the
2 IT Department had to “demonstrate to the Board” that they were reducing costs by cutting the
3 contractor headcount.

4 97. Further, CW 6 described the results from the IT Department of an employee
5 satisfaction survey were “abysmal.” He added that the results of this survey prompted Defendant
6 Galanti to give a speech to the department about addressing it. CW 6 also said that there was a
7 large exodus of IT employees near the end of his tenure in August 2018, and that he was
8 approximately the 26th employee to leave in the last three months of his employment. He noted
9 that Costco was seeking to add SOX-related IT personnel, such as a SOX Tactical Team
10 Member, since the revelations by the Company regarding their internal controls at the end of the
11 Class Period.

12 98. CW 6 also said it was a “gray area” as to who in Costco’s IT Department was
13 responsible for internal audits which he further described as “almost an informal process of risk
14 acceptance.” Further, CW 6 noted that Costco lacked a clear process for reporting any issues
15 employees found with third party vendors including how to report these issues or who to escalate
16 them to. Additionally, CW 6 said there were no compliance teams responsible for overseeing
17 any remediation measures that were supposed to be implemented when an issue was discovered.
18 As a result, CW 6 said some issues with vendors would get resolved while others were “left on
19 the table.”

20 99. Additionally, according to CW 7, a former Senior Business Analyst, the
21 managers, directors, and senior management of Costco did not know how to run an IT
22 project. CW 7 noted that almost all of his projects were cancelled and the last two were put on
23 hold. CW 7 also said his last project, which he spent two years on before leaving, were put on
24 hold at the time he left. Their philosophy was that workers could learn what they needed to
25 know on the job. CW 7 said that his direct report had no IT background and “certainly wasn’t
26 trained” in the area of IT before starting. CW 7 said that Costco’s IT personnel were promoted
27 based on length of tenure at the Company rather than ability. CW 7 said he left Costco because

1 he felt he could not get promoted based on the long-tenured employees he worked with who get
 2 promoted over him regardless of his IT experience. CW 7 also said that annual training for
 3 lower level IT employees consisted of “basic stuff,” such as how to lock one’s computer and the
 4 importance of doing so when the employee was away, for example.

5 100. Costco was fanatical about cutting costs and growing its business. However,
 6 Defendants did so to the detriment of the Company’s IT Department and the internal controls
 7 related to financial reporting. Rather than sufficiently delegating and overseeing the
 8 implementation and operation of an IT Department with resources commensurate with an
 9 operation with the revenues of Costco, Defendants oversaw a department without sufficient
 10 initial security controls, without a sufficient internal IT Department, and without adequate
 11 processes to remediate issues that would inevitably arise in an operation the size of Costco.

12 **2. The Deficiencies in IT Led to a Material Weakness in Costco’s**
 13 **Internal Controls, and In Particular with Regard to Change and**
Access Management

14 101. As noted above, the Company failed to provide the department with adequate
 15 resources, which led to unauthorized user access and change control management deficiencies.
 16 The deficiencies and required remediation measures revealed that the Company failed to
 17 adequately control user access and failed to adequately restrict which users were able to make
 18 changes in its IT systems. These issues were so pervasive in the IT Department (which was
 19 under the direct purview of the Individual Defendants per their duties under SOX) that the
 20 Individual Defendants knew or were deliberately reckless in not knowing of the material
 21 weaknesses earlier than October 2018 when they were revealed.

22 102. CW 1 specifically recalled that issues related to processes, access management,
 23 and governance controls were identified as having deficiencies throughout the whole IT
 24 Department. CW 1 said that the access controls were related to “internal” problems, people
 25 having improper access controls in relation to their jobs with the Company. He said these issues
 26 were routinely brought up with management but said management just did not listen. He
 27 explained that part of the problem was that Costco did not repeat oversight and audit of these

1 functions. CW 1 added that the internal audit team performed spot checks in SOX and PCI for
 2 controls. CW 1 said the Company would briefly implement governance controls and then stop.
 3 He also said there were many oversight and governance projects that Costco would begin in an
 4 effort to improve their overall IT compliance, but then the projects would abruptly end. CW 1
 5 said that Costco used a system called Archer⁹ to manage governance issues, including SOX, but
 6 that most governance issues discovered through Archer got “squashed at the VP level.”

7 103. CW 1 said he felt that Costco created “their own worst enemy” with Archer
 8 because most IT people did not know it existed, despite it being the locale of most of the
 9 information relevant for SOX compliance, and the information that was supposed to be entered
 10 into Archer was not being entered. He further explained that governance issues were entered
 11 into either Archer or ServiceNow but that Archer was the correct system and that many
 12 employees did not use it. As an example, CW 1 said that he had been entering his project
 13 information into the ServiceNow system for the first 18 months of his employment because
 14 nobody told him that Archer existed at Costco and that he was supposed to be using it. CW 1
 15 described the confusion surrounding Archer as a “circle of hell” as management was supposed to
 16 handle transfers.

17 104. Further, CW 1 stated that SOX controls at Costco sprawled across their entire IT
 18 ecosystem and that issues with GDPR compliance “drew light to a lot of weaker areas” in the IT
 19 department. CW 1 said that in the build-up to the implementation of GDPR, Costco’s weak
 20 internal controls “got Board attention,” including Defendants Jelinek and Galanti, because of the
 21 concerns over weak internal controls, GDPR compliance, and potential SOX compliance issues.
 22 CW 1 said that because of GDPR in particular, the Board was “highly engaged” on internal
 23 control problems leading into the implementation. CW 1 said Defendant Jelinek would have had
 24

25 ⁹ RSA Archer GRC Platform is a software that supports business-level management of
 26 governance, risk management, and compliance (GRC). The Platform allows users to adapt
 27 solutions to their requirements, build new applications, and integrate with external systems
 without touching a single line of code.

1 to have kept the Board aware of the control weaknesses because the Board would have to
 2 approve any spending to improve the IT situation. Further, CW 1 said Costco's former internal
 3 counsel Leigh Fulwood felt that GDPR was a legal issue. She took GDPR responsibilities away
 4 from IT, and the responsibilities were only returned to the department a year before
 5 implementation when Fulwood was replaced by Costco's current Corporate Counsel Sara Page.
 6 CW 1 also said that most tangible items associated with GDPR compliance took approximately
 7 six or seven months to finish.

8 105. Additionally, CW 1 said he was aware of several conversations at the Board level
 9 about concerns related to Costco's internal controls. He stated the Board met regarding the
 10 status of GDPR about once a quarter, but that the Board was meeting with monthly frequency
 11 with full implementation of GDPR coming up. CW 1 noted the meetings increased to monthly,
 12 occurring on the third or fourth Thursday in February, March, and April of 2018. He said that
 13 Defendants Jelinek and Galanti regularly attended the GDPR meetings. CW 1 did not attend any
 14 board meetings but he did prepare materials for his management team to present at some
 15 meetings and was briefed on the meetings afterwards. CW 1 said he presented data to
 16 management on GDPR and SOX compliance, and management in turn created PowerPoint
 17 presentations based off of the data CW 1 provided to present to the Board at those March, April,
 18 and May 2018 Board meetings. CW 1 said he heard about these meetings in March 2018 from
 19 Krishnan¹⁰ and Milroy¹¹, who most likely heard about it from Bowersock, who attended the
 20 meetings only occasionally. CW 1 said he believed that Defendants Jelinek and Galanti were in
 21 these meetings discussing internal control problems with the Board. CW 1 also stated that
 22 Defendants Jelinek and Galanti were involved in conversations related to a material weakness in
 23 Costco's IT department beginning in February/March 2018

24 _____
 25 ¹⁰ Krishnan remains employed with Costco as a Manager, Information Security, Government
 Risk Compliance and a Senior Enterprise Architect.

26 ¹¹ Milroy remains employed with Costco in Information Security Compliance and Identity and
 27 Access Management and her additional domains include Corporate Applications and
 eCommerce.

106. Further, CW 1 detailed a specific user access and change management issue. He said he retained access to Costco's eCommerce system long after he transferred to compliance. CW 1 said he had to request his access to the eCommerce be revoked after he left the department. He then had to "track down" management and "fight like hell" to finally get his access revoked. CW 1 also recalled, as did other CWs, that there was a Google form that could be used to submit information when someone was transferred within Costco, and that the forms should have been added to a Google sheet,¹² and that a user administrator is then supposed to make the transfer change. CW 1 added that since it was being done in a Google spreadsheet rather than a work flow tool, there was no way to tell if the work was ever actually done.

107. CW 1 said another user access issue related to emails on personal cell phones. CW 1 said that Costco did not have a Bring Your Own Device ("BYOD") policy, nor did the Company have any policy in place to revoke access to email on personal cell phones when employees would leave the Company. CW 1 said that while he no longer gets new emails, he still has access to all of his old emails even though he left in September 2018. He compared this to another former employer where his emails were wiped from his phone as soon as his employment was finished.

108. According to CW 3, the Company's lack of processes in the IT Department led to workers being granted "way more access" than they should have been. CW 3 said the Company was then left to "scramble" to try to address any issues before the auditors came in. CW 3 further explained that the Company had an issue with "knowledge transfer" as new workers the Company was hiring in the IT Department as part of an effort to cut costs were not qualified and were not capable of handling the work. CW 3 said that Costco prefers employees to be "home grown" and to promote from within the Company, to the extent that if you "made it past 90

¹² Google sheets is a part of the Google suite of online applications—other applications include the email platform "gmail" and the word processor "Google Docs." With Google sheets anyone with access can log into a document from anywhere. It is similar to using a spreadsheet on a program such as Microsoft excel, except that it is cloud based and online, such that it is readily accessible and editable to anyone with authorization.

1 days” you will never be fired and are “in like gold.” Rather than firing employees, CW 3 said
2 that Costco often moved employees to different positions or departments instead.

3 109. CW 3 stated that in reference to security measures in SAP, a lack of good
4 understanding of compliance and auditability and using junior consultants to implement the
5 system can lead to a “real mess.” CW 3 said at Costco there is “such a spider web of user access
6 systems” that the Company uses, not just for SAP, but for all applications. He said that in order
7 to do a true compliance check, you need to know what access people have across applications
8 because of potential vulnerabilities.

9 110. CW 3 said that during his time at Costco in mid-2017, he created a 50 page report
10 detailing the assessments and interviews that CW 3 and his colleague performed. He said that in
11 preparing this report, he interviewed members of nine different teams within the IT Department.
12 CW3 said that through those interviews, it became evident to him that, from an IT security
13 perspective, many people were not properly communicating with each other. He said that the
14 remediation measures Costco identified in their 2018 Form 10-K sounded very similar to his
15 recommendations in the report he submitted in May of 2017. CW 3 stated the report was
16 delivered to his supervisors, including the Director of Global SAP Platform Services.

17 111. CW 3 also noted that the remediation measures identified by Defendants in their
18 2018 Form 10-K were just the “tip” of what was necessary for Costco to remediate the issues in
19 the IT Department and that the Company should have known about the issues given his findings
20 over a year prior to October of 2018. CW 3 also stated he thought it was unusual that a company
21 would take a year to remediate. Further, CW 3 noted he was not aware of any internal follow-up
22 on the recommendations detailed in his report nor was he aware of a third party being brought in
23 to remediate the issues. CW 3 also said his colleague that still worked in change management at
24 Costco told him in October 2018 about the material weakness and the two agreed that Costco
25 should have known about the issues given CW 3’s findings more than a year prior.

26 112. CW 5 said the Company’s lack of formal processes led to certain third party
27 contractors in the department having access to “everything” in Costco’s system. For example,

1 CW 5 said contractors from ServiceNow had access to a database where they could see their
2 competitors' bids and contracts with Costco. CW 5 also noted that Oracle's IT contractors had
3 "no restrictions" regarding their system access and that "a lot of vendors," including Oracle, had
4 "full badge access" to Costco's IT facilities, rather than having access limited to the scope of
5 their particular project. CW 5 said this was consistent with the Company's culture in the IT
6 Department of letting IT contractors go wherever and do whatever they wanted.

7 113. According to CW 5, change management controls was one specific area affected
8 by the lack of resources dedicated to the IT Department. For example, he said that Costco had
9 "no process" for handing off responsibilities when one IT employee would replace another.
10 Additionally, CW 5 said that Costco used Google spreadsheets "for pretty much everything,"
11 including the onboarding and offboarding of IT Department employees and who should have
12 access to given programs. CW 5 said the spreadsheets were "used as a repository for
13 information about employees" and the use of spreadsheets made it too easy for someone to
14 change the information.

15 114. Further, CW 5 said that everything about the onboarding and offboarding process
16 was manual and nothing about it was automated. For example, it was up to the directors whose
17 projects IT contractors were working on to have the contractor's access revoked, but that "almost
18 never happened" and many contractors were never offboarded. Additionally, CW 5 said the
19 change management issues led to user access issues in that some third party IT contractors were
20 left with access to Costco's IT systems long after their tenure ended. CW 5 said his colleague
21 was left with access to "everything," including "a lot of sensitive stuff" and "his logins all
22 worked" for "at least a month" after he left Costco. CW 5 said there were a "baffling" number of
23 former contractors who were still listed as employees who should have access. CW 5 said he
24 witnessed a lack of oversight, lack of change control process, vendors unnecessarily having
25 unlimited access to IT systems and databases, and former employees still having access to
26 Costco's IT systems throughout his entire tenure with the Company.

1 115. Similarly, CW 6 said that Costco handled onboarding and offboarding of
2 contractors and tracking their access to Costco's system was done through Google spreadsheets.
3 He said he submitted a Google form that would then be input into the Google spreadsheet as part
4 of the onboarding process and it was up to the contractor's supervisor to "manually submit a
5 form" to the offboarding team to terminate the contractor's access, otherwise they would stay on
6 the system.

7 116. According to CW 6, a change management issue affected the registry where most
8 teams in the IT Department logged potential security threats. CW 6 said that around early 2018,
9 the management team charged with oversight of the department's internal risk registry was
10 disbanded and there was a six month period where the department lacked a centralized team
11 overseeing the registry. CW 6 also said the lack of resources dedicated to the department
12 resulted in a lack of effective and positive changes and project completions.

13 117. Further, CW 6 said there was seemingly no strategy for IT or its projects and little
14 prioritizing, resulting in a lack of effective and positive changes and project completions.
15 Additionally, CW 6 said he had heard KPMG, who had their offices right next to Costco's
16 internal audit department, had problems with Costco's controls and modules that held sensitive
17 financial information after her tenure with the Company. CW 6 said he believed that the affected
18 modules were for employee payroll and vendor payment, which would have exposed the bank
19 account information of employees and vendors.

20 118. As detailed by the Confidential Witnesses, the IT Department suffered a litany of
21 consequences from the lack of oversight and resources provided, or in this case not provided, by
22 management, including the Individual Defendants. The Individual Defendants had actual
23 knowledge of these deficiencies at least as early as February or March 2018. Further,
24 Defendants should have known of these deficiencies much earlier than that as they could not
25 have reasonably expected the IT Department to implement and maintain adequate internal
26 controls related to financial reporting given the lack of oversight, lack of resources, and ongoing
27 deficiencies in many different areas of the department.

K. Defendants Continue to Mislead the Market About the Adequacy of Costco's Internal Controls Over Financial Reporting

119. Despite these deficiencies, Defendants continued to mislead the market about their internal controls. Defendants made false statements in the 3Q2018 Form 10-Q SOX Certifications that they designed and implemented internal controls and that those internal controls worked. They also reiterated their supposed commitment to IT spending described above internal system disruptions.

120. All of these statements were false and misleading when made because (1) Defendants deprived the IT Department of the resources Costco needed to effectively detect risks and implement controls, and (2) as a result, the Company's access control and change management procedures were ineffective leading to a material weakness in internal controls related to financial reporting.

L. Defendants Begin to Reveal the Truth About The Material Weakness in Internal Controls

121. On October 4, 2018, the Company was finally forced to reckon with the consequences of deliberately neglecting its IT Department. On that date, in a press release filed with the SEC, Defendant Galanti informed the market that Costco was unable to ascertain the "effectiveness of its internal control over financial reporting as of September 2, 2018." The Company revealed issues related to "user access and program change-management over certain information technology systems that support the Company's financial reporting processes." The "access issues relate to the extent of privileges afforded users authorized to access company systems."

122. Costco revealed that it expected to report a material weakness in its internal controls related to financial reporting in its upcoming Form 10-K. However, in reporting this expected material weakness, the Company only vaguely mentioned remediation measures, instead saying only that "efforts have begun" without providing any specifics. Further, the Company stated "the material weakness will not be considered remediated until the applicable

1 controls operate for a sufficient period of time” and management can conclude the controls are
 2 working effectively. The Company estimated the material weakness would not be remediated
 3 until the end of FY 2019.

4 123. On October 4, 2018, the Company also held a conference call. In response to an
 5 analyst’s question about the material weakness, Defendant Galanti noted the issues related to
 6 granting access to “people within IT or contractors” and that “once they should have had that
 7 access relieved, it took a little long to do so.” Simply put, *“the controls weren’t in place.”*
 8 Additionally, Defendant Galanti stated that “[i]n some of the newer systems, there was no look
 9 back ability for certain things.” Finally, Defendant Galanti conceded that as of the time of the
 10 call, the material weakness *“should have been fixed”* but was not.

11 124. The market reacted accordingly to the uncertainty regarding Costco’s financial
 12 controls and reporting as shares declined by \$12.86 (as of close on October 5), a drop of
 13 approximately 5.55%, on high trading volume.

14 125. On October 4, 2018, Bloomberg reported that Costco’s “information-technology
 15 problem, which roiled its bookkeeping and sent the stock tumbling on [that day], was tied to
 16 workers getting access to financial data after they should have been cut off.” Bloomberg also
 17 noted that “a company official, [Defendant Galanti], was cryptic on [his] call with
 18 analysts.” Other reports on October 4, 2018, echoed the message. For example, Investor
 19 Business Daily explained that Costco “posted strong Q4 earnings after the close but warned of
 20 deficiencies in its information technology related to access to financial reporting systems.” And
 21 MarketWatch reported that Costco’s total sales numbers “surpassed Wall Street expectations”
 22 but that its shares fell “after the retailer said it expects to find ‘material weakness’ in internal
 23 controls over financial reporting when it releases its annual report.” The popular investment
 24 website “Seeking Alpha” ran an article with the headline, “Costco lower after earnings, material
 25 weakness disclosure.”

26 126. The publication Zacks Investment Research, a leading service tracking analyst
 27 estimates, reported that Costco beat estimates on both per share earnings and revenue, indicating

that Costco had outperformed expectations—and despite this its share price fell. The following chart shows the expected and actual results:

	Zacks Analyst Consensus	Costco's 4Q 2018 Results
Earnings Per Share	\$2.34	\$2.36
Revenue	\$44.40 billion	\$44.41 billion

127. Reports on October 5, 2018, were similar. Yahoo Finance reported that “despite an in-line bottom-line result and the top-line narrowly beating the consensus. The warehouse club raised concerns with its disclosure that it will report material weakness in its internal controls.” An article in Chain Store Today, a leading retail industry publication, was headlined, “Costco Q4 profit surges; reports flaw in financial controls.” The popular investment website Motley Fool ran an article titled “Why Costco Stock Fell Today” which stated that investors were “rattled by a potential accounting issue that the company disclosed.” The article went on to explain that Costco met analyst expectations for revenue and beat analyst expectations for profit per share, but stated that it had reported a “‘material weakness in internal control’ that spooked investors.” The San Francisco Chronicle wrote that “[d]espite a strong earnings report, Costco shares dropped 5.5 percent after the warehouse club said it will review past financial reports because of possible deficiencies.” Chanele2e,¹³ published an article entitled “Costco Investigates Access Control Issues Involving Financial systems.” The article, written by Joe Panettieri, commented on the statements made by Defendants in their October 4, 2018 earnings call and stated “[i]n a vague statement, the warehouse indicated that the access issue involved both internal employees and contractors.”

M. Defendants Final Revelation of the Truth About Their Internal Control Deficiencies

128. On the morning of October 26, 2018, Costco finally revealed the extent of the material weakness; the Company’s internal controls related to financial reporting were

¹³ Chanele2e is an online publication focused on research for MSPs, cloud services providers, strategic IT service providers, resellers, VARs, integrators & channel partners.

ineffective for financial results reported as of September 2, 2018, which meant the material weakness stretched all the way back to the end of the previous fiscal year. In its Form 10-k for FY 2018, signed by Defendants Jelinek and Galanti, Defendants revealed that they had “identified a material weakness in internal control related to ineffective information technology general controls (ITGCs) in the areas of user access and program change-management over certain information technology (IT) systems that support the Company’s financial reporting processes.” The Company further revealed that the internal weakness had far-reaching effects as the “business process controls (automated and manual) that are dependent on the affected ITGCs were also deemed ineffective because they could have been adversely impacted.”

129. Defendants blamed the material weakness in its financial reporting on three primary sources. First, Defendants stated they lacked sufficient documentation to maintain an effective change management and knowledge transfer program. This lack of documentation meant the Company “was overly dependent upon knowledge and actions of certain individuals with IT expertise, which led to failures resulting from changes in IT personnel.” Second, Defendants admitted they failed to properly train IT personnel on the importance of IT internal controls. Third, Defendants informed the market that the Company’s risk assessment processes were “inadequate to identify and assess changes in IT environments that could impact internal controls over financial reporting.” The lack of documentation and efficient risk assessment procedures was a violation under the Individual Defendants’ SOX duties as they are required to have sufficient documentation to support their assessment.

130. Costco further described the severity of this misstatement by warning of its potential repercussions. Costco disclosed that there was uncertainty regarding when and if the Company would be able to adequately remediate the issue—stating “if not remediated appropriately or timely” that certain bad results would occur—namely, a “loss of investor confidence” and an “advers[e] impact on [its] stock price.” Costco continued: “We are implementing remedial measures and, *while there can be no assurance that our efforts will be successful*, we plan to remediate the material weakness prior to the end of fiscal 2019.” Despite

its matter of fact tone, this statement is astounding—Costco was informing the market that its IT Department was in such disarray that it could not be sure that it would even be able to remediate the problem. Similarly, Costco warned of the dire consequences of failing to remediate, stating:

If we are unable to remediate the material weakness, or are otherwise unable to maintain effective internal control over financial reporting or disclosure controls and procedures, our ability to record, process and report financial information accurately, and to prepare financial statements within required time periods, could be adversely affected, which could subject us to litigation or investigations requiring management resources and payment of legal and other expenses, negatively affect investor confidence in our financial statements and adversely impact our stock price.

131. Costco's Auditor, KPMG, also provided an explanation of this situation as part of Costco's Form 10-K. They stated that "because of the effect of the material weakness" Costco had not "maintained effective internal control over financial reporting as of September 2, 2018 based on the COSO Framework. KPMG also wrote that the *"Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting."* This echoed the Company's recognition in that same Form 10-K that "management is responsible for establishing and maintaining adequate internal control over financial reporting." KPMG also explained the meaning of a "material" weakness, stating:

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management's assessment:

There were ineffective information technology general controls (ITGCs) in the areas of user access and program change-management over certain information technology (IT) systems that support the Company's financial reporting processes. As a result, business process automated and manual controls that were dependent on the affected ITGCs were ineffective because they could have been adversely impacted. These control deficiencies were a result of: IT control processes lacked sufficient documentation; insufficient knowledge and training of certain individuals with IT expertise; and risk-assessment processes

1 inadequate to identify and assess changes in IT environments and
2 personnel that could impact internal control over financial
reporting.

3 132. KPMG also explained some of the reasons why internal controls are of such
4 importance. It noted generally that “a company’s internal control over financial reporting is a
5 process designed to provide reasonable assurance regarding the reliability of financial reporting
6 and the preparation of financial statements for external purposes in accordance with generally
7 accepted accounting principles.” Implicit in this statement is that a lack of internal controls
8 means the Company cannot provide “reasonable assurance” regarding the reliability of their
9 financial reporting. It also explained that internal controls:

10 (1) pertain to the maintenance of records that, in reasonable detail,
11 accurately and fairly reflect the transactions and dispositions of the
12 assets of the company; (2) provide reasonable assurance that
13 transactions are recorded as necessary to permit preparation of
14 financial statements in accordance with generally accepted
15 accounting principles, and that receipts and expenditures of the
16 company are being made only in accordance with authorizations of
management and directors of the company; and (3) provide
reasonable assurance regarding prevention or timely detection of
unauthorized acquisition, use, or disposition of the company’s
assets that could have a material effect on the financial
statements.¹⁴

17 133. Defendants also laid out some of the measures that would be necessary to
18 remediate the material weakness in the Company’s internal controls related to financial
19 reporting. It warned that this remediation would “result in additional technology and other
20 expenses.” The remediation actions, which are discussed in greater depth in Section VI(N),
21 include: (i) creating and filling an IT Compliance Oversight function; (ii) developing a training
22 program addressing ITGCs and policies, including educating control owners concerning the
23 principles and requirements of each control, with a focus on those related to user access and
24 change-management over IT systems impacting financial reporting; (iii) developing and
25 maintaining documentation underlying ITGCs to promote knowledge transfer upon personnel

26
27 ¹⁴ A similar statement appears in the section of Costco’s Form 10-K for FY 2018 titled
“Management’s Annual Report on Internal Control Over Financial Reporting.”

1 and function changes; (iv) developing enhanced risk assessment procedures and controls related
 2 to changes in IT systems; (v) implementing an IT management review and testing plan to
 3 monitor ITGCs with a specific focus on systems supporting our financial reporting processes;
 4 and (vi) enhanced quarterly reporting on the remediation measures to the Audit Committee of the
 5 Board of Directors.

6 134. Investors reacted to the news of the Company providing additional details of the
 7 severity of the material weakness in its internal controls and the many remediation steps needed
 8 to fix the material problem related to financial reporting by doubling their trading volume and
 9 driving down Costco's share price by \$8.21, a drop of approximately 3.63%.

10 135. Even months, later on December 10, 2018, Forbes posted an article entitled
 11 "What To Expect From Costco's Q1 Earnings," that commented on the net earnings announced
 12 in the 2018 Form 10K (issued on October 25, 2018). The article stated "The retailer reported net
 13 earnings of \$2.36 per share, up 13% y-o-y. However, the stock traded down, as gross margins
 14 narrowed despite higher sales and the Company disclosed a material weakness in its internal
 15 controls."

16 **N. Remediation Measures Show the Severity of the Material Weakness in**
 17 **Internal Control and the Falsity of the Class Period Statements**

18 136. In its Form 10-K for FY 2018, filed on October 26, 2018, Costco provided a
 19 description of the expensive and widespread remediation measures it was planning to undertake.
 20 These remediation measures further revealed the severity of the failings within Costco.

21 137. ***First***, The revelation that Costco needed to create and fill an IT Compliance
 22 Oversight function revealed that such a function was previously missing (i.e., did not exist
 23 during the Class Period). Under the COSO framework the Company needed to have a "Control
 24 Environment" comprised of structures that provide the basis for carrying out internal controls
 25 across the organization. The third principle supporting the requirement of a Control
 26 Environment is management's responsibility to establish appropriate structures and authorities to
 27 achieve effective internal controls. As explained by KPMG's public guidance on internal

controls, to support this function means management must assign competent authorities across the organization to oversee functional areas such as IT. Here, Costco neglected to involve personnel with adequate competence related to IT risks, despite the fact that IT was a core component of Costco's business and necessary for a functioning control environment. The failure to implement an IT Compliance Oversight function prior to the end of the Class Period left Costco vulnerable to the risks associated with IT control failures and also rendered the SOX Certifications signed by the Individual Defendants during the Class Period false and misleading.

138. **Second**, Costco's revelation that it would need to "develop" a training program addressing internal controls and policies revealed that it lacked such a training program during the Class Period. The absence of such a training program in earlier periods was a failure at the most basic of levels. An effective Control Environment relies on the principle of the organization's "commitment to competence." A point of focus associated with this principle is the organization's provision of training to attract and develop sufficient competent personnel. The KPMG Reference Guide on internal controls asks, "Does the entity have programs in place (e.g., mentoring, training, etc.) that demonstrate management's commitment to attract, develop, and retain competent personnel?" The answer here, prior to the remediation effort, was no. In failing to establish a training program, the Individual Defendants failed to satisfy the duty to create an IT Department to adequately protect internal controls imposed by SOX and thus their certifications during the Class Period were false and misleading. Additionally, because Costco management failed to develop any training related to internal controls, IT personnel were allowed to engage in activities that created a reasonable possibility that a material misstatement would occur.

139. **Third**, Costco's revelation that it would be "developing and maintaining documentation underlying ITGCs to promote knowledge transfer upon personnel and function changes," revealed that it previously lacked such documentation. Chapter 4 of the COSO Framework states, "[e]ffective documentation assists in capturing the design of internal control and communicating the who, what, when, where, and why of internal control execution and

creates standards and expectations of performance and conduct.” KPMG’s public guidance uses even stronger language, stating: “Management’s documentation plays a critical role in supporting management’s assertion about internal control over financial reporting. Sufficient, appropriate documentation is a requirement in the COSO Framework and specifically discussed in the SEC Staff guidance.” Furthermore, SEC Release No. 33-8810, stated that “Management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment [of internal controls].” In fact, this same SEC release identifies management’s documentation of controls as an “integral part” of the basis to support management’s assertions regarding the effectiveness of controls. Yet, Costco’s remediation necessitated the *creation* of documentation related to internal controls to meet this most basic requirement of effective SOX, thus rendering the certifications signed by the Individual Defendants during the Class Period false and misleading. This remediation evidenced a massive gap in Costco’s practices, which would have affected other forms of compliance as well. That is, Costco management could not have offered appropriate training related to internal controls prior to the time that it created documentation of those internal controls. Nor could Costco’s management adequately assess the risk related to changes in IT systems without documentation. Similarly, the Individual Defendants and the Audit Committee could not effectively oversee Costco’s internal controls when the core internal controls did not exist or had not been documented.

140. ***Fourth***, Costco’s need to “develop enhanced risk assessment procedures and controls related to changes in IT systems” reveals the insufficiency of their prior risk assessment procedures. KPMG’s guidance states that identifying relevant risks to financial reporting is “an essential component of [internal control over financial reporting] because failure to understand the likely sources of misstatements increases the possibility of a material misstatement in the financial statements.” In fact, one of the principles underlying the Risk Assessment component of the COSO Framework is: “The organization identifies and assesses changes that could significantly impact the system of internal control.” According to KPMG, this principle is

1 “required to be met in order [for management] to conclude that [internal control over financial
 2 reporting] is effective.” Yet, here again, despite the fact that Costco was in the process of making
 3 significant changes to its IT systems, Costco’s internal controls were inadequate to assess the
 4 risk associated with such changes. Moreover, because Costco management could not have an
 5 adequate ability to assess the risks caused by such changes, Costco failed to have adequate
 6 controls in place to respond to those risks. Costco’s failure to have basic controls in place meant
 7 the Individual Defendants’ SOX Certifications were false and misleading because the Individual
 8 Defendants could not sufficiently assess the effectiveness of the Company’s controls without
 9 adequate risk assessment procedures.

10 141. ***Fifth***, Costco’s need to implement an “IT management review and testing plan to
 11 monitor ITGCs with a specific focus on systems supporting [its] financial reporting processes”
 12 reveals that it lacked such management review and testing prior to this remediation. This
 13 remediation expands on the actions described above to highlight that Costco management also
 14 failed to have appropriate review controls in place to monitor its ITGCs. Here again, the absence
 15 of such controls prior to the commencement of remediation was a basic lapse by Costco – and
 16 rendered its SOX Certifications false. For example, KPMG’s guidance states that
 17 “[m]anagement should pay particular attention to documenting the...design and operating
 18 effectiveness of management review controls.” Similarly, KPMG summarizes the SEC’s
 19 guidance on this issue as requiring management to “identify the risks to reliable financial
 20 reporting prior to identifying controls and monitoring them for effectiveness.” Thus, while the
 21 overall shortcomings in Costco’s internal controls and procedures were glaring, the specific
 22 technical weaknesses were obscured by the decision to not satisfy its duty to implement a review
 23 or testing plan prior to the remediation.

24 **O. Post-Class Period Revelations**

25 142. Even a full quarter after revealing the material weakness in the Company’s
 26 internal controls, Defendants were still scrambling to correct the issue leaving investors to guess
 27

1 as to the effectiveness of the Company's internal control and subsequent financial reporting.
2 Defendants also discussed the financial impact on Costco's IT spend.

3 143. On December 13, 2018, Defendants held a conference call to discuss its first
4 quarter 2019 results. In response to a question from an analyst about Costco's expenses,
5 Defendant Galanti admitted that "on the IT side, we've got a heck of a lot going on."

6 144. Additionally, on December 20, 2018, Costco filed with the SEC its first quarter
7 results in a Form 10-Q. The Form 10-Q again informed investors that Costco's "disclosure
8 controls and procedures were not effective . . . due to a material weakness in internal control over
9 financial reporting," and that the remediation of the weakness was still not completed.

10 145. Analysts took note of the continued weakness in Costco's internal controls related
11 to financial reporting. On December 24, 2018, Argus published a research report highlighting
12 this risk. Under a section titled "Management & Risks," Argus noted that Costco "reported a
13 material weakness in internal control in its annual report because of insufficient controls over
14 user access and management of program changes." The report further noted that Costco would
15 need to remediate deficiencies in its controls related to "access to certain financial and reporting
16 systems."

17 146. Additionally, on March 13, 2019, Costco filed with the SEC its second quarter
18 results in a Form 10-Q. The Form 10-Q again informed investors that Costco's "disclosure
19 controls and procedures were not effective . . . due to a material weakness in internal control over
20 financial reporting," and that the remediation of the weakness was still not completed.

21 147. On March 15, 2019, Corporate Watchdog Report published a report noting the
22 continued material weakness in Costco's controls.

VII. DEFENDANTS' MATERIALLY FALSE AND MISLEADING STATEMENTS AND OMISSIONS DURING THE CLASS PERIOD

148. During the Class Period, Defendants made numerous materially false and misleading statements and omissions.¹⁵

149. The gravity of the misstatements detailed in this Section is partially demonstrated by the substantial market reactions to the revelation of the truth. This reaction was sensible, *inter alia*, because the fraud concealed: (a) that Costco would need to undertake a vast effort and expend significant resources to transform its IT Department into one that would be capable of supporting the necessary internal controls; (b) that there was significant risk that Costco's reporting data would be inaccurate, especially until the issue was fully remediated, which risk could reasonable cause investors to discount their valuation of the Company; (c) that Costco could be subject to governmental or regulatory action regarding its internal controls and treatment of data, especially in an environment where inadequate data security can result in massive fines, such as fines up to 4% of revenue under the GDPR; and (d) it revealed a serious risk that Costco's low cost operating model was a house of cards—*e.g.*, that it was able to maintain SG&A spend of 10% of net sales (whereas its competitors were in the range of 15-20%) only because it cut corners in critical functions and that its fast-paced growth was not accompanied by a sustainable investment in critical controls.¹⁶

150. Costco made each of the statements described in this Section because they were filed by or on Costco's behalf with the SEC. Each of the Individual Defendants had ultimate control of the SEC filings described in this Section and this control is demonstrated, among other ways, because: (1) the Individual Defendants signed each of the SEC filings; (2) as Costco's

¹⁵ The statements that are ***bolded and italicized*** in this section are statements alleged to be false or misleading.

¹⁶ To the extent that any false statement in this section is representing a matter of opinion or is qualified as expressing a fact as to the speakers present understanding, that statement is false because defendants knew, or were reckless in not knowing, of the internal control deficiencies by no later than March 2018, and because any such statement could not be supported by a credible factual basis, given the condition of Costco's IT Department. (See Section VIII).

1 CEO and CFO, Defendants Jelinek and Galanti had direct control over what Costco said in
 2 public filings—especially in filings requiring his direct knowledge and involvement and as
 3 important as those described in this Section; (3) as Costco’s CEO and CFO, Defendants Jelinek
 4 and Galanti were required to have direct knowledge of and involvement in the SOX
 5 Certifications they each signed; (4) the Individual Defendants are members of the Board, and
 6 therefore were in control of what Costco said in formal public filings—especially in filings as
 7 important as those described in this Section; and (5) the ultimate control of the Individual
 8 Defendants is further established by their involvement in the very activity described in these
 9 statements.

10 151. Despite the Company’s knowledge (by at least March 2018) of the material
 11 weaknesses in internal controls that affected their financial reporting, Defendants made false and
 12 misleading statements and omissions in the 3Q2018 Form 10-q published on June 6, 2018, about
 13 their compliance with SOX, the effectiveness of their internal controls, and their contributions to
 14 their IT Department. The 3Q2018 Form 10-q was signed by Defendants Jelinek and Galanti.

15 152. The 3Q2108 Form 10-q stated the following:

16 Item 4—Controls and Procedures

17 *As of the end of the period covered by this Quarterly Report on Form 10-*
 18 *q, we performed an evaluation under the supervision and with the*
 19 *participation of management, including our Chief Executive Officer and*
 20 *Chief Financial Officer, of our disclosure controls and procedures (as*
 21 *defined in Rules 13a-15(e) and 15d-15(e) under the Securities and*
 22 *Exchange Act of 1934 (the Exchange Act)). Based upon that evaluation,*
 23 *our Chief Executive Officer and Chief Financial Officer concluded that,*
 24 *as of the end of the period covered by this Quarterly Report, our*
 25 *disclosure controls and procedures are effective.*

26 *There have been no changes in our internal control over financial*
 27 *reporting (as defined in Rules 13a-15(f) or 15d-15(f) of the Exchange Act)*
during our most recently completed fiscal quarter that have materially
affected or are reasonably likely to materially affect our internal control
over financial reporting.

153. This statement was false and misleading because, as discussed more fully in
 Section VI(J) and later admitted by Defendants themselves (See Sections VI(L) – (O)),

Defendants' internal controls and procedures were **not** effective as of this date of this statement. In fact, at the time this statement was made, Costco had a material weakness in internal controls over financial reporting (with a "material weakness" being the most severe form of internal control deficiency). As explained herein, that material weakness included ineffective information technology general controls ("ITGCs") in the areas of user access and program change-management over certain IT systems that support the Company's financial reporting processes. As a result, business process controls that were dependent on the affected ITGCs were ineffective because they could have been adversely impacted. These control deficiencies were a result of the fact that: Defendants consciously failed to adequately supervise and fund the IT Department to ensure that sufficient internal controls were both established and evaluated; IT control processes lacked sufficient documentation; IT personnel lacked sufficient knowledge and training; and risk-assessment processes were inadequate to identify and assess risks related to changes in IT environments and personnel that could impact internal control over financial reporting. As discussed in Section VIII, Defendants knew (or were deliberately reckless in not knowing) by no later than March 2018 of the material deficiencies in internal controls as they relate to financial reporting.

154. The 3Q2018 Form 10-Q also included two SOX Certifications. Defendants Jelinek and Galanti each signed their respective SOX Certifications and certified the following statement:¹⁷

I [●] certify that:

I have reviewed this Quarterly Report on Form 10-q of Costco Wholesale Corporation ("the registrant");

2) Based on my knowledge, ***this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;***

¹⁷ This qualifies as two separate statements – one made by Defendant Jelinek and one made by Defendant Galanti.

3) *Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;*

4) The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5) *The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):*

All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

1 *Any fraud, whether or not material, that involves management or other*
2 *employees who have a significant role in the registrant's internal control*
3 *over financial reporting.*

4 155. These statements were false and misleading because the Form 10-q contained
5 untrue statements of material fact as it relates to internal controls over financial reporting,
6 Defendants failed to design sufficient internal controls over financial reporting, and Defendants
7 failed to evaluate the effectiveness of these controls. As discussed more fully in Section VI(J),
8 and later admitted by Defendants themselves (See Sections VI(L) – (O)), Defendants' internal
9 controls and procedures were **not** effective as of this date of this statement. In fact, at the time
10 this statement was made, Costco had a material weakness in internal controls over financial
11 reporting (with a "material weakness" being the most severe form of internal control deficiency).
12 As explained herein, that material weakness included ineffective information technology general
13 controls ("ITGCs") in the areas of user access and program change-management over certain IT
14 systems that support the Company's financial reporting processes. As a result, business process
15 controls that were dependent on the affected ITGCs were ineffective because they could have
16 been adversely impacted. These control deficiencies were a result of the fact that: Defendants
17 consciously failed to adequately supervise and fund the IT Department to ensure that sufficient
18 internal controls were both established and evaluated; IT control processes lacked sufficient
19 documentation; IT personnel lacked sufficient knowledge and training; and risk-assessment
20 processes were inadequate to identify and assess risks related to changes in IT environments and
21 personnel that could impact internal control over financial reporting. Moreover, despite knowing
22 by no later than March 2018 about these deficiencies in internal controls (or being deliberately
23 reckless in not knowing), Defendants failed to disclose all significant deficiencies and material
24 weaknesses in the design or operation of internal control over financial reporting. (See Section
25 VIII).

26 156. The 3Q2018 Form 10-q also included two Certifications Pursuant to 18 U.S.C.
27 Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. Defendants

Jelinek and Galanti each signed these respective certifications and certified the following statement:¹⁸

In connection with the Quarterly Report of Costco Wholesale Corporation (the Company) on Form 10-q for the quarter ended May 13, 2018, as filed with the Securities and Exchange Commission (the Report), I, [] certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) *The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.*

157. This statement was false and misleading because it did not present “in all material respects the financial condition” of the Company. As discussed more fully in Section VIII, and later admitted by Defendants themselves (See Sections VI(L) – (O)), Defendants’ disclosure controls and procedures over financial reporting (which necessarily effects the “financial condition” of the Company) were **not** effective as of this date. In fact, at the time this statement was made, Costco had a material weakness in internal controls over financial reporting (with a “material weakness” being the most severe form of internal control deficiency). As explained herein, that material weakness included ineffective information technology general controls (“ITGCs”) in the areas of user access and program change-management over certain IT systems that support the Company’s financial reporting processes. As a result, business process controls that were dependent on the affected ITGCs were ineffective because they could have been adversely impacted. These control deficiencies were a result of the fact that: Defendants consciously failed to adequately supervise and fund the IT Department to ensure that sufficient internal controls were both established and evaluated; IT control processes lacked sufficient documentation; IT personnel lacked sufficient knowledge and training; and risk-assessment processes were inadequate to identify and assess risks related to changes in IT environments and

¹⁸ This qualifies as two separate statements – one made by Defendant Jelinek and one made by Defendant Galanti.

1 personnel that could impact internal control over financial reporting. As discussed in Section
 2 VIII, Defendants knew (or were deliberately reckless in not knowing) by no later than March
 3 2018 of the material deficiencies in internal controls as they relate to financial reporting.

4 158. In the 3Q2018 Form 10-q, Defendants also stated: “In addition to the other
 5 information set forth in the Quarterly Report on Form 10-q, you should carefully consider the
 6 factors discussed in Part I, Item 1A, “Risk Factors” in our Annual Report on Form 10-k, for the
 7 fiscal year ended September 3, 2017.” Thus, the 3Q2018 Form 10-q incorporated the “Risk
 8 Factors” in the Form 10-k for 2017 by reference. The Form 10-k for 2017 was signed by both
 9 Defendants Jelinek and Galanti.

10 159. In the 3Q2018, Form 10-q Defendants further stated; “*There have been no*
 11 *material changes in our risk factors from those disclosed in our [2017] Annual Report on*
 12 *Form 10-k.*” One of the Risk Factors in the Company’s 2017 Form 10-K, stated that the
 13 Company was “*currently making and will continue to make, significant technology*
 14 *investments to improve or replace critical information systems and processing capabilities.*”

15 160. These statement were false and misleading because as of the time the Form
 16 3Q2018 incorporated this statement from the 2017 Form 10-K by reference (June 6, 2018),
 17 Defendants were not “currently making” or continu[ing] to make” the significant technology
 18 investment necessary to safeguard their internal controls over financial reporting. As discussed
 19 more fully in Section VIII, and later admitted by Defendants themselves (See Sections VI(L) –
 20 (O)), Defendants’ disclosure controls and procedures over financial reporting (which necessarily
 21 affects the “financial condition” of the Company) were **not** effective as of this date. In fact, at
 22 the time this statement was made, Costco had a material weakness in internal controls over
 23 financial reporting (with a “material weakness” being the most severe form of internal control
 24 deficiency). As explained herein, that material weakness included ineffective information
 25 technology general controls (“ITGCs”) in the areas of user access and program change-
 26 management over certain IT systems that support the Company’s financial reporting processes.
 27 As a result, business process controls that were dependent on the affected ITGCs were

ineffective because they could have been adversely impacted. These control deficiencies were a result of the fact that: Defendants consciously failed to adequately supervise and fund the IT Department to ensure that sufficient internal controls were both established and evaluated; IT control processes lacked sufficient documentation; IT personnel lacked sufficient knowledge and training; and risk-assessment processes were inadequate to identify and assess risks related to changes in IT environments and personnel that could impact internal control over financial reporting. As discussed in Section VIII, Defendants knew (or were deliberately reckless in not knowing) by no later than March 2018 of the material deficiencies in internal controls as they relate to financial reporting.

161. On October 4, 2018, Defendants began to reveal the truth about the material weakness in internal controls. On October 4, 2018, Costco issued a Form 8-K for the Fourth Quarter and Fiscal Year 2018. Defendant Galanti signed the Form 8-K. Attached as an exhibit to the Form 8-K was a Press Release dated October 4, 2018. The Press Release stated:

While the Company is still completing its assessment of the effectiveness of its internal control over financial reporting as of September 2, 2018, in its upcoming fiscal 2018 Annual Report on Form 10-k, it expects to report a material weakness in internal control. ***The weakness relates to general information technology controls in the areas of user access and program change-management over certain information technology systems that support the Company's financial reporting processes. The access issues relate to the extent of privileges afforded users authorized to access company systems.*** As of the date of this release, there have been no misstatements identified in the financial statements as a result of these deficiencies, and the Company expects to timely file its Form 10-k.

Remediation efforts have begun; the material weakness will not be considered remediated until the applicable controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively. The Company expects that the remediation of this material weakness will be completed prior to the end of fiscal year 2019.

162. On that same day, October 4, 2018, at 9 pm GMT Defendants Galanti and Jelinek participated in an earnings call with analysts. On that call Defendant Galanti made the following statements:

1 A last topic, as was noted in this afternoon's press release, we plan to report
 2 in our Form 10-k the material weakness in internal control related to general
 3 IT controls. *These controls relate to internal user access and program*
 4 *change management over a certain of our IT systems that relate to our*
 5 *financial reporting processes.* I can tell you that there have been no
 6 misstatements identified in the financial statement as a result of the
 7 deficiencies, and we expect to timely file our Form 10-k.

8 *In terms of remediation, remediation efforts have begun, but material*
 9 *weakness will not be considered remediated until the applicable controls*
 10 *operate for a sufficient period of time and we can conclude through*
 11 *testing that the controls are operating effectively. We expect that the*
 12 *remediation of the material weakness will be completed prior to the end of*
 13 *fiscal 2019.*

14 Well, keep in mind, first of all, that we feel comfortable, and we feel that
 15 our -- ultimately, our auditors feel comfortable. We wouldn't have
 16 expressed the level of comfort we did in the press release about the time that
 17 there's no mistake [there's the timing that] we filed on time, including the
 18 K. *The issues had to do with internal user access, so people within IT or*
 19 *contractors and when somebody who may have had access to something*
 20 *they should have and sometimes that they -- once they should have had*
 21 *that access relieved, it took a little too long to do so. So the controls*
 22 *weren't in place. We should have done a better job. We went back as far*
 23 *as we could and looked back as far as we could in some systems for the*
 24 *entire fiscal year, which is what you want to do. In some of the newer*
 25 *systems, there was no look back ability for certain things. I can tell you*
 26 *with all the look backs that we have done and then our outside help has*
 27 *done has found no issues whatsoever in terms of misstatements or*
breaches. So that's what we can tell you. But we can't be more positive
than that until we release the Form 10-K. And as -- and so I don't want to
belittle it. We should have -- it should have been fixed, but it was internal
to us, not external. And we'll go from there.

163. These statement made on October 4, 2018, were false and misleading because
 despite the fact that Defendants began to reveal the material weakness in internal controls, they
 failed to disclose the full extent of the problems with access controls and change controls. They
 also failed to reveal precisely what caused the problems (described in paragraph 160), and failed
 to disclose to the market the full extent of the significant remediation measures that would have
 to be instituted to correct these material deficiencies in internal controls.

164. Defendants finally revealed the true extent of the problem and the significant
 remediation efforts required to fix. Then, on October 26, 2018 in their Form 10-K. See Section

1 VI(M). On this news, the stock dropped from a closing price of \$226.40 on the prior day to
2 \$218.19—a 3.63% drop on heavy volume of 3,995,362 shares.

3 **VIII. ADDITIONAL ALLEGATIONS SUPPORTING SCIENTER**

4 165. As described below, the Individual Defendants had actual knowledge that the
5 statements and omissions made by them were false and misleading, or acted with deliberate
6 reckless disregard for the truth or falsity of those statements and omissions. The Individual
7 Defendants' knowledge of, or deliberately reckless disregard for the truth, is demonstrated by
8 admissions and substantial direct and circumstantial evidence supporting a strong inference of
9 scienter.

10 **A. Defendants' Actually Knew About the Material Weakness In Internal 11 Controls Just Months Before the Class Period Even Begins**

12 166. The Individual Defendants knew, or were at least deliberately reckless in not
13 knowing, of the material weakness in their internal controls related to financial reporting by at
14 least March 2018, and not October 2018 as they revealed.

15 167. As noted by CW 1, the Board became "highly engaged" on internal control
16 problems leading into the Class Period as a result of the build-up to the implementation to
17 GDPR. CW 1 said the issues with GDPR compliance "drew light" to other areas of weakness in
18 the IT Department. In fact, CW 1 said that Defendant Jelinek would have had to keep the Board
19 informed of control weaknesses because the Board would have to approve any spending required
20 to improve the IT situation. CW 1 said he presented data to management on GDPR and SOX
21 compliance, and management in turn created PowerPoint presentations based off of the data CW
22 1 provided to present to the Board at those March, April, and May 2018 Board meetings.
23 Additionally, CW 1 said both Individual Defendants, in their roles as board members,
24 participated in conversations related to material weaknesses in the IT Department in February or
25 March of 2018. CW 1 also said that Defendant Jelinek was involved in "several conversations"
26 related to a weakness in Costco's internal controls in February or March of 2018. Further, CW 1
27 said the Board began having monthly, rather than the usual quarterly, meetings with full

1 implementation of GDPR coming up, and that Defendants Jelinek and Galanti regularly attended
2 these meetings.

3 168. That the Individual Defendants had Board materials detailing weaknesses in the
4 IT Department, regularly attended Board meetings where weaknesses in the Company's internal
5 controls were discussed, and discussed material weaknesses in the IT Department at least as
6 early as March 2018 shows that the Individual Defendants knew or were deliberately reckless in
7 not knowing of material weaknesses in Costco's internal controls when assuring the market of
8 the adequacy of those controls on June 6, 2018.

9 **B. Defendants Had Access to Information Alerting them to the Weakness in**
10 **Internal Controls**

11 169. In addition to those materials prepared for Board meetings discussed in Section
12 VIII(A), the Defendants had access to reports and data detailing the weaknesses in Costco's
13 internal controls.

14 170. CW 3 explained that he performed interviews of nine different teams within the
15 IT Department and generated a 50-page report detailing the assessments and interviews, which
16 report was delivered to the Director of Global SAP Platform services. He said that the
17 remediation issues Costco identified in their 2018 Form 10-K sounded very similar to the
18 recommendations in his 50 page report. He also noted that the remediation efforts identified in
19 the Form 10-K were just the "tip" of what was necessary to remediate the issues in the IT
20 Department, and that the Company should have known about the issues given his findings over a
21 year prior to October 2018. Accordingly, as CEO and CFO the Individual Defendants easily
22 could have accessed this data.

23 171. Furthermore CW 1 explained that SOX governance issues were entered into one
24 of two systems—one was called Archer and another was called ServiceNow. As CEO and CFO
25 the Individual Defendants easily could have accessed this data.

26 172. Additionally, Defendants had access to information insofar as many of the
27 inadequate practices were plainly visible to anyone within the Company. For example, CW 5

describes that Costco used Google sheets for “pretty much everything” including for tracking information on the onboarding and offboarding of IT employees—and that they were used as a “repository for information about employees.” CW 6 similarly stated that supervisors had to “manually submit a form” to the offboarding team to terminate the contractor’s access, otherwise they would stay in the system. As CW 1 explained, because this was being done in a Google spreadsheet rather than a work flow tool, there was no way to tell if it was ever actually done. This was obviously an insufficient process for a company of the scale of Costco and it was readily visible to the Defendants.

C. The Extensive Remedial Efforts Support an Inference of Scienter

173. That Costco’s internal controls required such drastic remediation measures further shows Defendants knew or were deliberately reckless in not knowing of the material weakness in their internal controls related to financial reporting. Rather than personally ensuring the implementation and maintenance of effective internal controls (as they were required to do), the Individual Defendants oversaw an underfunded IT Department rife with access control and change management problems. Defendant Galanti even went so far as admitting in Costco’s 4Q2018 earnings call on October 4, 2018, that the material weakness “should have been fixed” prior to the date of the call and explained: “[T]he controls weren’t in place . . . We should have done a better job.”

174. On October 25, 2018, Defendants disclosed to the market the extensive measures that would be required to remediate the material weakness in their internal controls related to financial reporting. Defendants revealed that Costco’s IT Department; (1) lacked a compliance oversight function; (2) lacked a training program to educate employees on ITGCs, (3) lacked a sufficient documentation program for ITGCs; (4) lacked sufficient risk assessment procedures and controls related to IT systems; and (5) lacked a sufficient ITGC review and testing plan. The fact that the IT Department *lacked* these basic and important safeguards supports that Defendants acted with knowledge (or were deliberately reckless) when they signed their SOX Certification and made other statements concerning the efficacy of these internal controls.

1 175. The fact that these controls were lacking is a *prima facie* showing that
 2 Defendants made false and misleading statements or omissions with scienter. Defendants could
 3 not have possibly designed and evaluated effective internal controls, and then certified as to the
 4 effectiveness of those same controls during the Class Period, when these controls never existed
 5 in the first place. Defendants admitted that these controls only came into being at the end of the
 6 Class Period, *after* the material weakness was announced.

7 **D. Conscious Neglect of the IT Department Supports an Inference of Scienter**

8 176. Costco's conscious neglect of its IT Department further supports an inference of
 9 Defendants' scienter. As explained in Section (See Section VI(J)), the accounts of the former
 10 employees combine to paint a picture of an IT Department in complete shambles as a result of
 11 being systematically deprived of attention and resources.

12 177. Confidential witnesses collectively confirm that (1) management did not want to
 13 spend on IT and IT lacked necessary resources (CWs 1, 2, 3, and 6); (2) security features were
 14 built in afterwards (CWs 1, and 3); Costco used antiquated IT systems (CW1) and failed to
 15 update change management systems (CW 3); (3) Costco lacked appropriate staff for Governance
 16 Risk and Compliance (CW 3) and for other departments (CW 4); (4) Costco lacked appropriate
 17 training and oversight (CWs 1, 2, 3, 5, 6, and 7); and (5) as a result, access control and change
 18 management were serious problems for the IT Department (CWs 1, 2, 3, 5, and 6).

19 178. As corroboration of the former employees who stated that Defendants did not
 20 want to spend the necessary funds on the IT Department, the Individual Defendants allocated
 21 significantly less of their spending on IT than did their competitors.

22 179. Simply put, an IT Department systematically deprived of resources and attention
 23 would not be able to maintain adequate internal controls. Importantly, Defendants could not
 24 have performed even the most basic of evaluations using IT systems without knowing, or being
 25 deliberately reckless in not knowing, of the fundamental weakness in the Company's internal
 26 controls.
 27

E. Defendants' SOX Certifications Support an Inference of Scienter

180. By signing the SOX Certifications the Individual Defendants asserted they maintained a certain level of involvement or supervision over the Company's internal controls. However, given the state of the Company's IT Department, any level of involvement or evaluation of the IT Department would have revealed the glaring deficiencies in internal controls. As a result, the Defendants knew or were deliberately reckless in not knowing of the access control and change management issues in the IT Department prior to June 6, 2018, when Defendants assured the market their internal controls were adequate and there had been no material changes to risks identified in their 2017 Form 10-K.

181. Rather than failing to spot a rounding error in accounting software, or some other similarly minor deficiency, the Individual Defendants oversaw, and asserted that they personally evaluated, an IT Department, that by their own admission on October 26, 2018, completely lacked an IT compliance oversight function, lacked a training program addressing ITGCs, lacked documentation underlying ITGCs, lacked sufficient risk assessment procedures and controls, and lacked an IT management review and testing plan to monitor ITGCs.

182. While the CEO and CFO are allowed to delegate the actual implementation and daily oversight of the internal controls under SOX, they are not allowed to delegate the evaluation of those operations. Even a cursory evaluation of Costco's IT Department prior to the filing of the Company's 3Q2018 Form 10-Q would have revealed the glaring deficiencies in access control and change management sprawling throughout the IT Department.

183. Additionally, in fulfilling their duty to evaluate the Company's internal controls and sign a certification attesting to the adequacy of those controls quarterly and annually, the Individual Defendants would require some form of regular reports, and/or a review of the controls put in place over financial reporting. If the Individual Defendants were receiving regular reports on the state of the controls that existed in the IT Department, or reviewing the controls put in place for financial reporting they would have known, or been deliberately reckless in not knowing, of the department-wide weaknesses and the material weakness in access control

1 and change control functions. If the Individual Defendants were not receiving some form of
 2 regular reports and/or not conducting a review of the controls put in place over financial
 3 reporting then they knowingly, or at the very least, were deliberately reckless when they misled
 4 the market in claiming that they designed and implemented internal controls over financial
 5 reporting under SOX.

6 **IX. LOSS CAUSATION**

7 184. During the Class Period, as detailed herein, Defendants engaged in a knowingly,
 8 or deliberately, reckless course of conduct that artificially inflated the price of Costco's securities
 9 and operated as a fraud or deceit on Class Period purchasers of Costco's securities by failing to
 10 reveal and misrepresenting the adverse facts detailed herein. Later, when Defendants' prior
 11 misrepresentations and fraudulently reckless course of conduct were revealed to the market, the
 12 price of Costco's securities declined significantly as the prior artificial inflation was released
 13 from the Company's share price.

14 185. As a result of their purchases of Costco's securities during the Class Period, Lead
 15 Plaintiff and the other Class members suffered economic loss, *i.e.*, damages, under the federal
 16 securities laws. Defendants' false and misleading statements had the intended effect and caused
 17 Costco's common stock to trade at artificially inflated levels throughout the Class Period, closing
 18 at \$197.66 per share on June 6, 2018 (the first day of the Class Period), closing at a high of
 19 \$244.21 per share on September 11, 2018, and then falling to \$218.19 per share at closing on
 20 October 26, 2018.

21 186. By concealing from investors, the adverse facts detailed herein, Defendants
 22 presented a misleading picture of Costco's business and internal controls. As Defendants began
 23 to reveal these adverse facts to the market, the price of Costco's securities fell dramatically.
 24 From the day of the partial revelation of the truth, on October 4, 2018, to close the following day,
 25 Costco's stock dropped from a closing price of \$231.68 to \$218.82—a 5.55% drop on heavy
 26 volume of 7,379,026 shares. On the date of the second revelation, October 26, 2018, Costco's
 27 stock dropped from a closing price of \$226.40 on the prior day to \$218.19—a 3.62% drop on

heavy volume of 3,995,362 shares. This decline removed the artificial inflation from the price of Costco's stock, causing economic loss to investors who had purchased Costco's securities during the Class Period.

187. The decline in the price of Costco's securities following these revelations was a direct result of the nature and extent of Defendants' fraudulent misrepresentations being revealed to investors and the market. The timing and magnitude of the price declines in Costco's securities and market reactions to the news negate any inference that the loss suffered by Lead Plaintiff and the other Class members was caused by changed market conditions, macroeconomic or industry factors, or Company-specific facts unrelated to Defendants' fraudulent conduct.

188. The economic loss, *i.e.*, damages, suffered by Lead Plaintiff and the other Class members was a direct result of Defendants' fraudulent scheme and course of conduct to artificially inflate the price of Costco's securities and the subsequent material decline in the value of Costco's securities when Defendants' prior misrepresentations and omissions and other fraudulent conduct were revealed.

X. APPLICATION OF PRESUMPTIONS OF RELIANCE

189. To the extent that reliance is an element of their claims, Lead Plaintiff and the Class members are entitled to a presumption of reliance under *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972), because the claims asserted herein against Defendants are predicated upon omissions of material fact where there was a duty to reveal material information.

190. To the extent that reliance is an element of their claims, Lead Plaintiff and the Class members are also entitled to a presumption of reliance on Defendants' material misrepresentations and omissions pursuant to the fraud-on-the-market theory:

- (a) Costco common stock was actively traded on the NASDAQ, an informationally efficient market, throughout the Class Period;
- (b) Costco stock traded at high volumes during the Class Period;
- (c) Costco filed an annual report and quarterly financial reports with the SEC;

- 1 (d) Costco communicated with public investors by means of established market
2 communication mechanisms, including through regular dissemination of press
3 releases on the major news wire services and through other wide-ranging public
4 revelations, such as communications with the financial press, securities analysts,
5 and other similar reporting services;
- 6 (e) the market reacted promptly to public information disseminated by Costco, for
7 example, the market price of Costco stock decreased by 5.5% On October 5,
8 2018, when the possibility of a material weakness in the Company's internal
9 controls related to financial reporting was announced, and again decreased by
10 3.63% on October 26, 2018, when Costco finally revealed the extent of the
11 material weakness in internal controls;
- 12 (f) Costco stock was covered by numerous securities analysts employed by major
13 brokerage firms who wrote reports that were publicly available and entered the
14 public marketplace;
- 15 (g) the material misrepresentations and omissions alleged herein would tend to induce
16 a reasonable investor to misjudge the value of Costco's securities;
- 17 (h) without knowledge of the misrepresented or omitted material facts alleged herein,
18 Lead Plaintiff and other Class members purchased Costco's securities between the
19 time Defendants misrepresented or failed to reveal material facts and the time the
20 true facts began to be revealed; and
- 21 (i) Options in Costco's stock were actively traded in an informationally efficient
22 market based on the value of Costco and the price of its common stock,
23 which traded on the NASDAQ, an informationally efficient market, throughout
24 the Class Period.
- 25
26
27

1 **XI. NO SAFE HARBOR**

2 191. The statutory safe harbor provided by the PSLRA for forward-looking statements
3 under certain circumstances does not apply to any of the materially false and misleading
4 statements and omissions alleged herein.

5 192. *First*, Defendants' statements and omissions alleged to be false and misleading
6 relate to historical facts or existing conditions, and omissions are not protected by the statutory
7 safe harbor. Defendants' false and misleading statements and omissions alleged herein are not
8 forward-looking because such statements: (1) relate to historical or current fact; (2) implicate
9 existing conditions; and (3) do not contain projections of future performance or future objective.
10 To the extent that any of the alleged false and misleading statements and omissions might be
11 construed to touch on future intent, they are mixed statements of present facts and future intent
12 and are not entitled to safe harbor protection with respect to the part of the statement that refers
13 to the present.

14 193. *Second*, any purported forward-looking statements were not accompanied by
15 meaningful cautionary language because any risks that Defendants warned of had already come
16 to pass, and any cautionary language did not mention important factors of similar significance to
17 those actually realized. Additionally, to the extent Defendants included any cautionary language,
18 such language was not meaningful because any potential risks identified by Defendants had
19 already manifested. To the extent Defendants included any cautionary language, it was not
20 precise and did not relate directly to any forward-looking statements at issue. Defendants'
21 cautionary language was boilerplate and did not change during the Class Period, despite the fact
22 that conditions had materially changed.

23 194. *Third*, to the extent that there were any forward-looking statements that were
24 identified as such, Defendants are liable because, at the time each of those forward-looking
25 statements were made, the speaker knew the statement was false when made.
26
27

XII. CLASS ACTION ALLEGATIONS

195. Lead Plaintiff brings this federal securities class action pursuant to Rule 23 of the Federal Rules of Civil Procedure on behalf of himself and all persons and entities that purchased Costco securities during the period from June 6, 2018 through October 25, 2018, inclusive (the “Class Period”) and were damaged thereby, except as excluded below (the “Class”).

196. Excluded from the Class are: (i) Defendants; (ii) members of the immediate family of any Individual Defendant; (iii) any person who was an officer or director of Costco during the Class Period; (iv) any firm, trust, corporation, or other entity in which Defendants have, has, or had a controlling interest; and (v) the legal representatives, affiliates, heirs, successor-in-interest, or assignees of any such excluded person, including Costco’s employee retirement and/or benefit plan(s) and their participants or beneficiaries, to the extent they made purchases through such plan(s).

197. The Class members are so numerous that joinder of all members is impracticable. During the Class Period, Costco had more than 435 million common shares outstanding, which shares were actively traded on the NASDAQ.

198. While the exact number of Class members is unknown to Lead Plaintiff at this time, and can only be ascertained through appropriate discovery, it is likely that the proposed Class numbers in the thousands and is geographically widely dispersed. Record owners and other Class members may be identified from records maintained by Costco and may be notified of the pendency of this action by mail, using a form of notice similar to that customarily used in securities class actions.

199. Lead Plaintiff’s claims are typical of the claims of the Class members. All the Class members were similarly affected by Defendants’ conduct in violation of the Exchange Act as alleged herein.

200. Lead Plaintiff will fairly and adequately protect the interests of the Class members. Lead Plaintiff has retained counsel competent and experienced in class and securities litigation.

1 201. There is a well-defined community of interest in the questions of law and fact
 2 involved in this case. Common questions of law and fact exist as to all Class members, and
 3 predominate over any questions solely affecting individual Class members. The questions of law
 4 and fact common to the Class include, without limit:

- 5 (a) whether the federal securities laws were violated by Defendants' acts and
 6 omissions as alleged herein;
- 7 (b) whether statements made by Defendants to the investing public during the Class
 8 Period contained material misrepresentations;
- 9 (c) whether the Defendants' statements omitted material facts that Defendants had a
 10 duty to reveal;
- 11 (d) whether Defendants' statements omitted material facts necessary in order to make
 12 the statements made, in light of the circumstances under which they were made,
 13 not misleading;
- 14 (e) whether Defendants acted knowingly or deliberately recklessly in issuing false
 15 and misleading financial statements;
- 16 (f) whether the price of Costco securities during the Class Period was artificially
 17 inflated because of Defendants' conduct complained of herein;
- 18 (g) whether reliance may be presumed pursuant to the fraud-on-the-market doctrine
 19 and/or the presumption of reliance afforded by *Affiliated Ute Citizens of Utah v.*
 20 *United States*, 406 U.S. 128 (1972);
- 21 (h) whether the individuals were controlling persons of Costco; and
- 22 (i) whether and to what extent the Class members suffered losses due to Defendants'
 23 fraudulent conduct.

24 202. A class action is superior to all other available methods for the fair and efficient
 25 adjudication of this controversy because, among other things, joinder of all Class members is
 26 impracticable. Furthermore, because the damages suffered by the individual Class members may
 27 be relatively small, the expense and burden of individual litigation make it impossible for

members of the Class to individually redress the wrongs done to them. There will be no difficulty in the management of this action as a class action.

COUNT I

**Violation of § 10(b) of the Exchange Act and Rule 10b-5
Promulgated Thereunder Against All Defendants
for Violations of Section 10(b) and Rule 10b-5 Promulgated Thereunder**

203. Lead Plaintiff repeats and realleges each and every allegation contained above as if fully set forth herein.

204. This Count is asserted against all Defendants and is based upon Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder by the SEC.

205. During the Class Period, Defendants engaged in a plan, scheme, conspiracy and course of conduct, pursuant to which they knowingly or deliberately recklessly engaged in acts, transactions, practices and courses of business which operated as a fraud and deceit upon Lead Plaintiff and the other Class members; made various untrue statements of material facts and omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; and employed devices, schemes and artifices to defraud in connection with the purchase and sale of securities. Such scheme was intended to, and, throughout the Class Period, did: (i) deceive the investing public, including Lead Plaintiff and other Class members, as alleged herein; (ii) artificially inflate and maintain the market price of Costco securities; and (iii) cause Lead Plaintiff and other Class members to purchase or otherwise acquire Costco securities at artificially inflated prices. In furtherance of this unlawful scheme, plan and course of conduct, Defendants, and each of them, took the actions set forth herein.

206. Pursuant to the above plan, scheme, conspiracy and course of conduct, each of the Defendants participated directly or indirectly in the preparation and/or issuance of the quarterly and annual reports, SEC filings, press releases and other statements and documents described above, including statements made to securities analysts and the media that were designed to influence the market for Costco securities. Such reports, filings, releases and statements were

1 materially false and misleading in that they failed to reveal material adverse information and
2 misrepresented the truth about Costco.

3 207. By virtue of their positions at Costco, the Individual Defendants had actual
4 knowledge of the materially false and misleading statements and material omissions alleged
5 herein and intended thereby to deceive Lead Plaintiff and the other Class members, or, in the
6 alternative, the Individual Defendants acted with deliberately reckless disregard for the truth in
7 that they failed or refused to ascertain and reveal such facts as would reveal the materially false
8 and misleading nature of the statements made, although such facts were readily available to the
9 Individual Defendants. Said acts and omissions of the Defendants were committed willfully or
10 with reckless disregard for the truth. In addition, each Individual Defendant knew or recklessly
11 disregarded that material facts were being misrepresented or omitted as described above.

12 208. Additional information showing that Defendants acted knowingly or with
13 deliberately reckless disregard for the truth is peculiarly within Defendants' knowledge and
14 control. As the senior managers and/or directors of Costco, the Individual Defendants had
15 knowledge of the details of Costco's internal affairs.

16 209. The Individual Defendants are liable both directly and indirectly for the wrongs
17 complained of herein. Because of their positions of control and authority, the Individual
18 Defendants were able to and did, directly or indirectly, control the content of the statements of
19 Costco. As officers and/or directors of a publicly-held company, the Individual Defendants had
20 a duty to disseminate timely, accurate, and truthful information with respect to Costco's
21 businesses, operations, future financial condition and future prospects. As a result of the
22 dissemination of the aforementioned false and misleading reports, releases and public statements,
23 the market price of Costco securities were artificially inflated throughout the Class Period. In
24 ignorance of the adverse facts concerning Costco which were concealed by Defendants, Lead
25 Plaintiff and the other Class members purchased or otherwise acquired Costco securities at
26 artificially inflated prices and relied upon the price of the securities, the integrity of the market
27

1 for the securities and/or upon statements disseminated by Defendants, and were damaged
2 thereby.

3 210. During the Class Period, Costco securities were traded on an active and efficient
4 market. Lead Plaintiff and the other Class members, relying on the materially false and
5 misleading statements described herein, which the Defendants made, issued or caused to be
6 disseminated, or relying upon the integrity of the market, purchased or otherwise acquired
7 Costco securities at prices artificially inflated by Defendants' wrongful conduct. Had Lead
8 Plaintiff and the other Class members known the truth, they would not have purchased or
9 otherwise acquired said securities, or would not have purchased or otherwise acquired them at
10 the inflated prices that were paid. At the time of the purchases and/or acquisitions by Plaintiff
11 and the Class, the true value of Costco securities was substantially lower than the prices paid by
12 Plaintiff and the other Class members. The market price of Costco securities declined sharply
13 upon public revelation of the facts alleged herein to the injury of Lead Plaintiff and Class
14 members.

15 211. By reason of the conduct alleged herein, Defendants knowingly or deliberately
16 recklessly, directly or indirectly, have violated Section 10(b) of the Exchange Act and Rule 10b-
17 5 promulgated thereunder.

18 212. As a direct and proximate result of Defendants' wrongful conduct, Lead Plaintiff
19 and the other Class members suffered damages in connection with their respective purchases,
20 acquisitions and sales of Costco securities during the Class Period, upon the revelation that
21 Costco had been disseminating misrepresented financial statements to the investing public.

22 **COUNT II**

23 **Against the Individual Defendants** 24 **for Violations of Section 20(a) of the Exchange Act**

25 213. Lead Plaintiff repeats and realleges each and every allegation contained in the
26 foregoing paragraphs as if fully set forth herein.
27

1 214. During the Class Period, the Individual Defendants participated in the operation
2 and management of Costco, and conducted and participated, directly and indirectly, in the
3 conduct of the Costco's business affairs. The Individual Defendants knew the adverse non-
4 public information about Costco's misstatements because of their senior positions at the
5 Company.

6 215. As officers and/or directors of a publicly owned company, the Individual
7 Defendants had a duty to disseminate accurate and truthful information, and to correct promptly
8 any public statements issued by Costco which had become materially false or misleading.

9 216. Because of their positions of control and authority as senior officers, the
10 Individual Defendants were able to, and did, control the contents of the various reports, press
11 releases and public filings which Costco disseminated in the marketplace during the Class Period
12 concerning the misrepresentations. Throughout the Class Period, the Individual Defendants
13 exercised their power and authority to cause Costco to engage in the wrongful acts complained
14 of herein. The Individual Defendants therefore, were "controlling persons" of Costco within the
15 meaning of Section 20(a) of the Exchange Act. In this capacity, they participated in the unlawful
16 conduct alleged which artificially inflated the market price of Costco securities.

17 217. Each of the Individual Defendants, therefore, acted as a controlling person of
18 Costco. By reason of their senior management positions and/or being directors of Costco, each
19 of the Individual Defendants had the power to direct the actions of, and exercised the same to
20 cause, Costco to engage in the unlawful acts and conduct complained of herein. Each of the
21 Individual Defendants exercised control over the general operations of Costco and possessed the
22 power to control the specific activities which comprise the primary violations about which
23 Plaintiff and the other Class members complain.

24 218. By reason of the above conduct, the Individual Defendants and/or Costco are
25 liable pursuant to Section 20(a) of the Exchange Act for the violations committed by the
26 Company.

XIII. PRAYER FOR RELIEF

WHEREFORE, Lead Plaintiff respectfully prays for judgment against the Defendants as follows:

A. Determining that this action is a proper class action maintained under Rule 23 of the Federal Rules of Civil Procedure, certifying Lead Plaintiff as class representative, and appointing Levi & Korsinsky, LLP as class counsel pursuant to Rule 23(g);

B. Determining and declaring that Defendants violated the Exchange Act by reason of the acts and omissions alleged herein;

C. Awarding Lead Plaintiff and the Class compensatory damages against all Defendants, jointly and severally, in an amount to be proven at trial together with interest thereon;

D. Awarding Lead Plaintiff and the Class their reasonable costs and expenses incurred in this action, including but not limited to attorneys' fees and costs incurred by consulting and testifying expert witnesses; and

E. Granting such other and further relief as this Court may deem just and proper.

XIV. DEMAND FOR TRIAL BY JURY

Lead Plaintiff hereby demands a trial by jury of all issues so triable.

Dated: April 16, 2019

Respectfully submitted,

BRESKIN JOHNSON TOWNSEND PLLC

By: /s/ Roger Townsend

Roger Townsend, WSBA #25525
1000 Second Avenue, Suite 3670
Seattle, WA 98104
Tel: (206)652-8660
rtownsend@bjtlegal.com

Local Counsel

LEVI & KORSINSKY, LLP (Trial Counsel)
Eduard Korsinsky*
55 Broadway, 10th Floor

New York, NY 10006
Tel: (212) 363-7500
Fax: (212) 363-7171
Email: ek@zlk.com

Nicholas I. Porritt*
Adam M. Apton*
Adam C. McCall*
1101 30th St. NW, Suite 115
Washington, D.C. 20007
Tel: (202) 524-4290
Fax: (202) 333-2121
Email: nporritt@zlk.com
Email: aapton@zlk.com
Email: amccall@zlk.com
**Pro hac vice applications forthcoming*

Attorneys for Plaintiff and Lead Counsel for the Class

LABATON SUCHAROW LLP

By: /s/ Carol C. Villegas

Carol C. Villegas
Jake Bissell-Linsk*
140 Broadway
New York, NY 10005
Telephone: (212) 907-0700
Facsimile: (212) 818-0477
Email: cvillegas@labaton.com
Email: jbissell-linsk@labaton.com
**Pro hac vice application forthcoming*

Additional Attorneys for Lead Plaintiff and the Class

CERTIFICATE OF SERVICE

I certify that, on the date stamped above, I caused this document to filed with the Clerk of the Court using the CM/ECF system, which will serve all parties by emailing notice of filing to their counsel of record.

/s/ Carol C. Villegas
Carol C. Villegas